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CONSOLIDATED ANALYSIS

	AUTHOR	Bill Number
Franchise Tax Board	**Scott**	**SB 657**

SUBJECT Conformity Act of 2002

SUMMARY

This bill would conform state law to federal treatment of the:

1. Pension plan, Coverdell Education Saving Account (ESA), and Qualified Tuition Plan changes contained in the federal Economic Growth and Tax Relief Reconciliation Act of 2001, (P.L. 107-16), (EGTRRA) (See explanation beginning on page 3.)
2. Contributions of publicly traded stock to private foundations (See explanation beginning on page 8.)
3. Gifts of appreciated property for alternative minimum tax purposes (See explanation beginning on page 10.)
4. Federal S corporation election, requiring corporations with a valid S election for federal purposes to be an S corporation for California purposes (See explanation beginning on page 13.)
5. Discharge of indebtedness of an S Corporation (See explanation beginning on page 15.)
6. Deduction of club dues. (See explanation beginning on page 17.)
7. Deduction of excess compensation for officers (See explanation beginning on page 19.)
8. Disallowance of lobbying and political expenses (See explanation beginning on page 22.)
9. Estimated tax payments of individuals (See explanation beginning on page 23.)
10. Numerous federal changes made between January 1, 1998, and January 1, 2001. (See explanation beginning on page 25.)

PURPOSE OF BILL

The author's staff has indicated that the purpose of the bill is to conform to the recent federal changes to pension plans, Coverdell ESA, and Qualified Tuition Plans, thus permitting greater financial freedom to many Californians. The bill is also to conform to other federal items making the preparation of the California income and franchise tax returns less confusing.

EFFECTIVE/OPERATIVE DATE

This bill is a tax levy. Thus, it would be effective immediately, and unless otherwise specified, it would apply to taxable years beginning on or after January 1, 2002. The provisions of this bill that conform to portions of EGTRRA apply to taxable years beginning before January 1, 2011.

This bill would become operative only if AB 1122 (Corbett) is chaptered.

REVENUE TABLE

Estimated Conformity Impact of SB 657			
4/25/02			
Fiscal Years			
(In Millions)			
Provision	2002-3	2003-4	2004-5
Coverdell Education Savings Accounts	Negligible loss	Negligible loss	Negligible loss
Qualified Tuition Plans	Minor loss	-$1	-$1
IRA Provisions	-$9	-$9	-$13
Pension Provisions	-$35	-$38	-$45
Donations of Publicly Traded Stock to Private Foundations	-$5	-$5	-$4
AMT on Charitable Contributions of Appreciated Property	-$12	-$10	-$10
Mandated S vs. C Election	$10	$10	$10
Discharge of S Corporation Indebtedness	$2	$3	$3
Club Dues	$12	$9	$10
Executive Compensation	$4	$4	$5
Lobbying Expenses	$7	$7	$7
Federal Estimate Payment Requirements	$210	$10	$10
Conformity 1998-2000	$5	$20	$18.5
Totals	$189	$0	-$9.5

ANALYSIS

Conforming to federal tax law is generally desirable because it is less confusing for the taxpayer. With conformity, the taxpayer is required to know only one set of rules. Additionally, the taxpayer needs to maintain only one set of books. Conformity also eases the burden of the Franchise Tax Board to administer the law by utilizing many federal forms, instructions, and regulations. In addition, whenever possible the department uses federal information to verify that taxpayers pay the proper amount of tax. This eliminates the need for the taxpayer to submit the same information to both the IRS and the department.

1. PENSION PLAN, COVERDELL EDUCATION SAVING ACCOUNT, AND QUALIFIED TUITION PLAN CHANGES CONTAINED IN EGTRRA

Prior to June of 2001, California law was generally in conformity with the federal pension plan, education retirement savings account (the name was later changed to Coverdell Education Savings Accounts), and Qualified State Tuition Plan provisions. These federal provisions were changed by the EGTRRA. The federal changes generally enhanced the benefits and eased the administration of pension plans, Coverdell ESAs, and Qualified Tuition Plans. California, however, has not conformed to the EGTRRA provisions affecting pension plans, Coverdell ESAs, and Qualified Tuition Plans.

The following is a summary of the 2001 federal changes to the pension plan, Coverdell ESA, and Qualified Tuition Plan provisions that would be conformed to by this bill. The section numbers are references to the section of the EGTRRA. A complete explanation of the pension plan, Coverdell ESA, and Qualified Tuition Plan federal and state laws affected by this bill is attached as **Appendix I**[1].

Sec. 401. Modifications to education individual retirement accounts. Increases, from $500 to $2,000, the annual limit on contributions to education IRAs (aka Coverdell education savings account). Increases, on a joint return, the phase out so that it is twice that of a taxpayer filing a single return. Includes expenditures for qualified elementary and secondary education as qualified education expenses. Waives age limitations for special needs children. Permits corporations to contribute to education IRAs. Permits annual contributions to be made until the filing date (not including extensions) for a tax year. Extends the time for return of excess contributions. Provides for coordination of the Hope credit, Lifetime Learning credit, and qualified tuition program provisions.
Sec. 402. Modifications to qualified tuition programs. Permits an eligible educational institution (currently, limited to a state or agency or instrumentality thereof) to maintain a qualified tuition program, provided such program has received a ruling that such program meets the applicable requirements for a qualified tuition program. Excludes from gross income education distributions from qualified tuition programs. Permits the transfer of credits from one qualified tuition program to another qualified program for the benefit of the same beneficiary without the transfer being considered a distribution. Permits expenses for the special needs services of a special needs beneficiary.
Sec. 601. Modification of IRA contribution limits. Increases the Individual Retirement Account (IRA) annual dollar contribution limit to $3,000 for 2002 through 2004, $4,000 for 2005 through 2007, and $5,000 for 2008 and thereafter, with indexing in $500 increments thereafter. Provides, for individuals age 50 and older, that such limit shall be increased by $500 for 2002 through 2005 and by $1,000 for years 2006 and thereafter.

[1] Information for Appendix I derived from the Conference Report for EGTRRA, House Report 107-84.

Sec. 602. Deemed IRAs under employer plans. Deems certain voluntary employee contributions to accounts and annuities as IRAs rather than pension plans.
Sec. 611. Increase in benefit and contribution limits. Increases annual benefit limits to $160,000 and annual contribution limits to $40,000. Increases, over five years, the annual contribution limits for 401 (k) and other employer-sponsored plan to $15,000. Sets indexes for inflation in various increments on such increased limits.
Sec. 612. Plan loans for subchapter S owners, partners, and sole proprietors. Revises requirements relating to plan loans for subchapter S owners, partners, and sole proprietors.
Sec. 613. Modification of top-heavy rules. Revises specified top-heavy rules. Revises the definition of key employee. Requires that employer-matching contributions be taken into account for purposes of minimum contribution requirements. Provides for distributions during the last year before a determination date is taken into account. Excludes from the definition of top-heavy plan: (1) cash or deferred arrangements using alternative methods of meeting nondiscrimination requirements; and (2) defined contribution plans using alternative methods of meeting nondiscrimination requirements.
Sec. 614. Elective deferrals. Provides that elective deferrals shall not be taken into account for purposes of limits on certain plan contributions.
Sec. 615. Deferred compensation plans of state and local governments and tax-exempt organizations. Repeals specified coordination requirements for deferred compensation plans of state and local governments and tax-exempt organization.
Sec. 616. Deduction limits. Revises certain deduction limits for stock bonus and profit sharing trusts and for defined contribution plans.
Sec. 617. Option to treat elective deferrals as after-tax Roth contributions. Provides for optional treatment of elective deferrals as Roth contributions.
Sec. 631. Catch-up contributions for individuals age 50 or over. Allows individuals who are age 50 or older to make additional contributions to an applicable employer plan.
Sec. 632. Equitable treatment for contributions of employees to defined contribution plans. Sets forth requirements relating to equitable treatment for contributions of employees to defined contribution plans. Increases the 25 percent of compensation limitation on annual additions under a defined contribution plan to 100 percent. Declares that certain contributions by church plans are not to be treated as exceeding a specified limit. Increases the 33 and one-third percent of compensation limitation on deferrals under deferred compensation plans of state and local governments and tax-exempt entities (section 457 plans) to 100 percent of compensation.
Sec. 633. Faster vesting of certain employer matching contributions. Provides for faster vesting of certain employer matching contributions.
Sec. 634. Modification to minimum distribution rules. Provides for the modification of the life expectancy tables concerning the minimum distribution rules.
Sec. 635. Clarification of tax treatment of division of section 457 plan benefits upon divorce. Revises requirements relating to tax treatment of division of section 457 plan benefits upon divorce. Applies the taxation rules for qualified plan distributions pursuant to a qualified domestic relations order to distributions made pursuant to a domestic relations order from a section 457 plan. Provides that a section 457 plan is not to be treated as violating the restrictions on distributions from such plans due to payments to an alternate payee under a qualified domestic relations order.
Sec. 636. Provisions relating to hardship distributions. Directs the Secretary to reduce from 12 months to six months the safe harbor relief period during which an employee is prohibited from making elective contributions and employee contributions in order for a distribution to be deemed necessary to satisfy a hardship financial need. Provides that a hardship distribution from any qualified plan is not an eligible rollover distribution.

Sec. 637. Waiver of tax on nondeductible contributions for domestic or similar workers. Provides for a waiver of tax on certain nondeductible contributions made for pension coverage for domestic or similar workers, by providing that the ten-percent excise tax on nondeductible contributions does not apply to contributions to a SIMPLE 401(k) plan or SIMPLE IRA that are nondeductible solely because they are not made in connection with a trade or business of the employer. Declares that nothing in such amendment shall be construed to infer the proper treatment of nondeductible contributions under the laws in effect before such amendment.
Sec. 641. Rollovers allowed among various types of plans. Permits rollovers from and to various types of plans under the Internal Revenue Code.
Sec. 642. Rollovers of IRAs into workplace retirement plans. Permits individual retirement plan (IRA) rollovers into workplace retirement plans only if certain conditions are met.
Sec. 643. Rollovers of after-tax contributions. Permits rollover of after-tax contributions in an exempt trust under specified conditions..
Sec. 644. Hardship exception to 60-day rule. Sets forth a hardship exception to the 60-day rule. Authorizes the Secretary to waive the 60-day rollover period if the failure to waive such requirement would be against equity or good conscience, including cases of casualty, disaster, or other events beyond the reasonable control of the individual subject to such requirement.
Sec. 645. Treatment of forms of distribution. Sets forth requirements for treatment of forms of distribution available under transferor and transferee plans under the Internal Revenue Code.
Sec. 646. Rationalization of restrictions on distributions. Revises restrictions on distributions, including the same desk exception. Repeals business sale requirements.
Sec. 647. Purchase of service credit in governmental defined benefit plans. Authorizes trustee-to-trustee transfers to purchase permissive service credit with respect to governmental defined benefit plans.
Sec. 648. Employers may disregard rollovers for purposes of cash-out amounts. Allows employers to disregard rollovers for purposes of cash-out amounts, under retirement plan provisions of the Internal Revenue Code.
Sec. 649. Minimum distribution and inclusion requirements for section 457 plans. Revises minimum distribution and inclusion requirements for section 457 plans.
Sec. 651. Repeal of 160 percent of current liability funding limit. Increases, until repeal (2004), the current liability full funding limit.
Sec. 652. Maximum contribution deduction rules modified and applied to all defined benefit plans. Revises maximum contribution deduction rules. Applies such rules to all defined benefit plans.
Sec. 654. Treatment of multi-employer plans under section 415. Makes limitation rules on benefits and contributions for qualified benefit plans (section 415 plans) inapplicable to governmental or multi-employer plans. Sets forth special rules relating to the combination or aggregation of multi-employer plans
Sec. 655. Protection of investment of employee contributions to 401(k) plans. Modifies the effective date of the rule excluding certain effective date deferrals from the definition of individual account plan
Sec. 656. Prohibited allocations of stock in S corporation ESOP. Requires any employee stock ownership plan (ESOP) holding employer securities consisting of stock in an S corporation to provide that no portion of the assets of the plan attributable to (or allocable in lieu of) such employer securities may, during a nonallocation year, accrue (or be allocated directly or indirectly under any qualified plan of the employer) for the benefit of any disqualified person. Defines a nonallocation year as any ESOP plan year if, at any time during it such plan holds employer securities consisting of stock in an S corporation, and disqualified persons own at least 50 percent of the number of shares of stock in that corporation. Prescribes attribution rules. Imposes an excise tax for violations of such prohibition.
Sec. 657. Automatic rollovers of certain mandatory distributions. Makes a direct rollover the default option for mandatory distributions exceeding $1,000 and that are eligible rollover distributions from qualified retirement plans.

Sec. 658. Clarification of treatment of contributions to multi-employer plan. States that a determination regarding the taxable year with respect to which a contribution to a multi-employer pension plan is deemed made shall not be treated as a method of accounting.
Sec. 661. Modification of timing of plan valuations. Revises requirements relating to timing of plan valuations.
Sec. 662. ESOP dividends may be reinvested without loss of dividend deduction. Allows applicable dividends of ESOPs to be reinvested without loss of dividend deduction.
Sec. 663. Repeal of transition rule relating to certain highly compensated employees. Repeals a transition rule relating to certain highly compensated employees under the Tax Reform Act of 1986.
Sec. 664. Employees of tax-exempt entities. Directs the Secretary to modify certain regulations with respect to certain plan participation by employees of tax-exempt entities.
Sec. 665. Clarification of treatment of employer-provided retirement advice. Excludes from gross income any fringe benefit qualifying as a qualified retirement planning service.
Sec. 666. Repeal of the multiple use test. Repeals the multiple use test, and directs the Secretary to prescribe regulations, as necessary, including ones permitting appropriate aggregation of plans and contributions.

THIS BILL

This bill would conform California tax law to the above-listed provisions of the EGTRRA.

If California does not act to at least partially conform to the 2001 federal changes, many pension plans may no longer qualify for favorable tax treatment under California law. This qualification issue has occurred in the past and is a major concern with the 2001 federal changes. To prevent future qualification problems, this bill contains provisions that would prevent the disqualification of pension or retirement savings plans due to any future federal changes.

This bill would not permit (without future state legislation) any future federal increases in IRA deductions or exclusion amounts for elective employee deferrals under 401(k), 403(b), and 457 plans to apply for state taxation purposes.

This bill would freeze the amounts deductible or excludable for California purposes to the amounts allowed under the EGTRRA. This bill would, however, exclude from taxable income any pension and retirement savings plan earnings (inside build-up) due to the differences between amounts deductible or excludable for state purposes and future federal increases in these amounts, as well as prevent any disqualification of the plan itself for state purposes resulting from future federal changes.

Preserving the qualification of many pension plans is consistent with language contained in the federal Employee Retirement Income Security Act of 1974 (ERISA), which pre-empts any state law (including any state tax law) that relate to any ERISA qualified plan. The extent of this federal preemption has been the subject of litigation around the country, and the issue is currently pending before the U.S. Supreme Court. However, IRAs (including Coverdell Education Savings Accounts), Qualified Tuition Plans, and 457 plans are not governed by ERISA. There is also case law suggesting that states may have different tax treatment for salary deferral amounts under 401(k) and 403(b) plans.

All the changes made by the EGTRRA sunset on December 31, 2010. By referencing federal law, the provisions of this bill would also sunset on the same date.

LEGISLATIVE HISTORY

AB 131 (Corbett, 2001/2002) would conform to two provisions of EGTRRA, Act Sections 641 and 647, relating to the rollovers allowed among various types of plans and the purchase of service credit in governmental defined benefit plans**.** AB 131 is enrolled.

AB 1743 (Campbell, 2001/2002) would conform to the EGTRRA provisions contained in this bill, except that AB 1743 would also fully conform to the new EGTRRA federal credits related to pension plans. However, AB 1743 would not prevent the disqualification of qualified plans due to future federal changes in retirement savings. AB 1743 is in the Assembly Revenue and Taxation Committee.

AB 1744 (Corbett, 2001/2002) would conform to two provisions of EGTRRA, Act Sections 641 and 647, relating to the rollovers allowed among various types of plans and the purchase of service credit in governmental defined benefit plans**.** AB 1744 is in the Assembly Appropriations Committee.

AB 1122 (Corbett, 2001/2002) contains the exact same provisions as this bill. AB 1122 is in enrollment.

SB 1256 (Brulte, 2001/2002) contains the same EGTRRA provisions as this bill. Additionally, SB 1256 would not prevent the disqualification pension plans due to future federal changes in retirement savings. Presently, SB 1256 is in the Senate Revenue and Taxation Committee.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws. *Illinois, New York, and Michigan* automatically conform to federal law. Therefore, these states are in conformity with the EGTRRA changes. *Florida* does not have a personal income tax. *Florida's* corporation income tax automatically conforms to federal changes. Massachusetts and Minnesota conform to the IRC with a specified date. *Minnesota* recently passed legislation to conform to EGTRRA. The construction of *Massachusetts* law permits qualified federal retirement plans to be qualified under *Massachusetts* law: however, *Massachusetts* has not conformed to the higher deductible or excludible amounts that are allowed under EGTRRA.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Estimated Conformity Impact of SB 657 4/25/02			
Fiscal Years			
(In Millions)			
Provision	2002-3	2003-4	2004-5
Coverdell Accounts	---------- Negligible loss ----------		
Qualified Tuition Plans	minor loss	-$1	-$1
IRA Provisions	-$9	-$9	-$13
Pension Provisions	-$35	-$38	-$45

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion:

In addition to the above conformity losses, baseline revenue losses for Coverdell ESAs and IRA and pension provisions total $40, $40, and $60 million for fiscal years 2002-03, 2003-04, and 2004-05 respectively. With respect to Coverdell ESAs and IRAs, baseline losses will result automatically due to the non-reporting for state tax purposes of the inside build-up of earnings for taxpayers taking advantage of the new federal limits. For pension issues, baseline losses will result automatically due to federal ERISA provisions (assuming federal preemption). Not making audit assessments in subsequent years contributes to a significant increase in conformity revenue losses over time. There is no baseline loss relative to expansion of qualified tuition plans.

2. CONTRIBUTIONS OF PUBLICLY TRADED STOCK TO PRIVATE FOUNDATIONS

Existing state and federal laws allow deductions from income for charitable contributions. Individuals generally can deduct amounts up to 30% of their adjusted gross income for contributions to qualified charities. Corporations can deduct amounts up to 10% of their taxable income.

Under federal law, taxpayers generally are allowed to deduct the fair market value (FMV) of property, including certain appreciated property contributed to a charitable organization, other than private foundations. However, in the case of a charitable contribution of inventory, other ordinary income property, or short-term capital gain property, the amount of the deduction is limited to the taxpayer's basis in the property.

The California Personal Income Tax Law (PITL) conforms to federal law for gifts of all types of property. Under the Corporation Tax Law (CTL), a taxpayer's charitable contribution deduction is limited to the taxpayer's adjusted basis in the property, regardless of the type of property donated.

Under federal and state laws, the amount of the charitable contribution deduction for gifts of appreciated property to private foundations is generally limited to the taxpayer's basis in the property. Under federal law since 1984**,** a gift of qualified appreciated stock to a private foundation is not limited to the taxpayer's basis in the stock, but instead the entire FMV of the stock is deductible as a contribution. Qualified appreciated stock is defined as stock for which market quotations are readily available on an established securities market (the stock must be publicly traded). When the federal provision for contributions of publicly traded stock to private foundations was enacted in 1984; it contained a sunset date of December 31, 1994. The federal provision was thereafter extended in increments of 12 to 18 months. In 1998, the special provision for the donation of publicly traded stock to private foundations became permanent under federal law.

CALIFORNIA LAW

California law, under the PITL, conformed to the federal rule regarding the deduction for a contribution of publicly traded stock to private foundations until its federal sunset on December 31, 1994. California has not conformed to any of the subsequent federal law extensions of that sunset date or the 1998 federal change making the special rule permanent. Therefore, under current California law, the amount of any charitable contribution to private foundations is generally limited to the taxpayer's basis in the property being donated.

THIS BILL

This bill would conform the PITL to existing federal law by allowing the amount of a charitable contribution of publicly traded stock to a private foundation to be the FMV of the stock. This bill does not conform to this provision under the CTL.

LEGISLATIVE HISTORY

SB 1300 (1997-98) and SB 1760 (1999-2000) would have conformed the Personal Income Tax Law (PITL) to the federal treatment of publicly traded stock to private foundations. The income tax provisions in SB 1300 were amended out and SB 1760 failed passage from the Senate Appropriation Committee. SB 49 (2001) would have conformed to federal treatment under both the PITL and CTL. SB 49 failed passage from the Senate Revenue and Taxation Committee.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws. The review of these states' tax laws indicates that they conform to federal law as it relates to the contribution of publicly traded stock to a private foundation.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Estimated Conformity Impact of SB 657			
4/25/02			
Fiscal Years			
(In Millions)			
Provision	2002-3	2003-4	2004-5
Donations of Publicly Traded Stock to Private Foundations	-$5	-$5	-$4

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion:

Estimates for this proposal are based on original federal projections, adjusted to account for current economic trends.

3. CONFORMITY TO THE TREATMENT OF GIFTS OF APPRECIATED PROPERTY

Prior to 1993, federal law, for purposes of computing the alternative minimum tax (AMT), treated the deduction of charitable contributions of appreciated property as a tax preference item. The excess of the fair market value of the property over the taxpayer's adjusted basis at the time of the contribution was treated as an item of tax preference for AMT purposes during those years. The federal Revenue Reconciliation Act of 1993 eliminated contributions of appreciated property as a tax preference item.

Existing federal and state laws provide for AMT. AMT was established to ensure that no taxpayers with substantial economic income avoid all tax liability by using exclusions, deductions, and credits (tax preference items).

Alternative minimum taxable income (AMTI) is computed by adding back to regular taxable income tax preference items and by making certain adjustments to taxable income. Tax preference and adjustment items are those tax benefits that have been identified as being instrumental in generating tax savings by reducing a taxpayer's taxable income. Examples of such items are standard and itemized deductions, accelerated cost recovery system depreciation, certain mining costs, depletion, and the deduction for charitable contributions of appreciated property. State law provides an AMT rate of 7% for taxpayers subject to the Personal Income Tax Law and an AMT rate of 6.64% for taxpayers subject to the Corporation Tax Law.

Under federal and state laws, in computing regular taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the fair market value of property contributed to a charitable organization, including certain appreciated property donated to a charitable organization. However, in the case of a charitable contribution of inventory or other ordinary income property or short-term capital gain property, the amount of the deduction is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, a taxpayer's deduction is limited to the adjusted basis of the property if the contributed property is not used by the donee for its tax-exempt purpose. For most contributions of appreciated property made by corporate taxpayers, the allowable charitable contribution deduction for regular tax is limited to the adjusted basis of the contributed property.

Under existing state and federal laws, donations of property may be treated as charitable contributions for purposes of the deduction if the property is contributed to or used by a qualified organization (public, private, or governmental), as follows:

- For corporations, the deduction for charitable contributions is limited to 10% of the taxpayer's net income (except as specified). Contributions in excess of 10% may be carried over to the following five succeeding taxable years.

- For individuals, the amount deductible for a contribution of property that has appreciated in value depends upon whether the property is ordinary income or capital gain property. Real estate typically is considered capital-gain property. For contributions to certain types of organizations, including governmental units, the maximum allowable deduction is limited to 50% of the taxpayer's adjusted gross income (AGI). In the case of appreciated capital-gain property, the deduction may be limited to 30% of the taxpayer's AGI.

Under federal law, contributions of appreciated property are not treated as tax preference items for purposes of AMTI.

CALIFORNIA LAW

Under state law, for purposes of computing AMTI, the amount of any deduction (generally the fair market value for individuals) for charitable contributions of appreciated property (real, personal, or intangible) that exceeds the taxpayer's adjusted basis in the property is treated as a tax preference item and is added back to AMTI. In most cases, the AMTI calculation for corporations is not impacted since the allowable charitable contribution deduction for regular tax is limited to the adjusted basis of the contributed property.

THIS BILL

This bill would conform California law to existing federal law by eliminating the deduction for contributions of appreciated property as an item of tax preference. As a result, taxpayers no longer would need to include in their computation of AMTI the amount by which any allowable deduction for contributions of appreciated property exceeds the taxpayer's adjusted basis in the contributed property. Generally, this change would mean taxpayers may have a lower overall tax liability since it is less likely a taxpayer would become subject to AMT.

LEGISLATIVE HISTORY

SB 1760 (Speier, 1999-2000) would have conformed the Personal Income Tax Law (PITL) to the federal treatment of this provision. SB 1760 failed passage from the Senate Appropriation Committee.

This provision is also contained in AB 1122 (Corbett, 2002). AB 1122 is in enrollment.

OTHER STATES' INFORMATION

Only *Alaska, California, Florida, Iowa, Maine, Minnesota, Nebraska, and New York* impose an AMT comparable to the federal provisions. *Iowa, Maine, Nebraska, and New York* conform to the federal treatment of contributions of appreciated property. *Minnesota* conforms to the federal treatment of contributions of appreciated property except that 100% of a contribution made to an out-of-state charity (besides the federal government) is a tax preference item. *Alaska and Florida* do not have individual income taxes.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Estimated Conformity Impact of SB 657			
4/25/02			
Fiscal Years			
(In Millions)			
Provision	2002-3	2003-4	2004-5
AMT on Charitable Contributions of Appreciated Property	-$12	-$10	-$10

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion

Estimates for this proposal are based on original federal projections in the Revenue Reconciliation Act of 1993, adjusted to take into account current trends in the fair market values associated with the types of assets subject to this proposal, namely stock and real property.

4. REQUIRE CORPORATIONS WITH VALID FEDERAL S CORPORATION ELECTION TO BE AN S CORPORATION FOR CALIFORNIA LAW

BACKGROUND

For income years beginning on or after January 1, 1987, California conformed to the federal S corporation provisions, with specified exceptions. For federal purposes, the taxable income or loss of an S corporation is taken into account by the corporation's shareholders, rather than by the entity, regardless whether such income is distributed. The shareholders of a small business corporation may elect to have the corporation be treated as an S corporation.

Under California law, in addition to the pass-through of the S corporation's income and deductions to its shareholders, an S corporation continues to be subject to the franchise tax, in an amount equal to the greater of the minimum tax or 1.5% of its net income for the income year. Unlike other corporations, however, an S corporation is allowed to compute depreciation under the modified cost recovery system (MACRS) and is subject to the same at-risk and passive activity loss rules as an individual. An S corporation is not subject to the alternative minimum tax. Credits are allowed against this corporate level tax in an amount equal to one-third of the amount otherwise allowable.

A corporation that is an S corporation for California purposes is generally not allowed to be included in a combined report of a unitary group.

CALIFORNIA LAW

A taxpayer with a valid S corporation election for federal purposes is an S corporation for California purposes, unless the taxpayer elects to be a C corporation.

THIS BILL

Effective for taxable years beginning on or after January 1, 2002, this would require all taxpayers with a valid S corporation election for federal purposes to be an S corporation for state purposes. The effective date of the S corporation election for those taxpayers required to be an S corporation under the provisions of this bill would be January 1, 2002, for California purposes.

This bill would provide transitional relief regarding estimated tax payments. A California C corporation that becomes an S corporation, due to the provisions of this bill, may request to have part (the amount in excess of the S corporation's expected tax liability) of the estimated tax payment transferred to the principal income tax accounts of its shareholders.

LEGISLATIVE HISTORY

This provision is also contained in AB 1122 (Corbett, 2002). AB 1122 is in enrollment.

OTHER STATES INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Florida, Illinois, *Massachusetts*, and *Minnesota* do not allow separate S corporation elections.

Michigan treats S corporations as any other business entity for purposes of imposing the "single business tax," which is Michigan's version of income tax. Therefore, Michigan's tax law is not comparable to California tax law as it relates to S corporation elections.

New York allows a separate election for S corporation status.

A cursory review was done of all other states. In addition to New York, only Arkansas and Georgia allow separate S corporation elections. Various information readily available to the public was reviewed including individual state tax forms and websites.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Estimated Conformity Impact of SB 657 4/25/02			
Fiscal Years			
(In Millions)			
Provision	2002-3	2003-4	2004-5
Mandated S vs. C Election	$10	$10	$10

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion:

The estimate is an order of magnitude impact based on the collective judgment of legal, audit and research staff.

5. DISCHARGE OF INDEBTEDNESS OF AN S CORPORATION

Background

In general, an S corporation is not subject to the corporate income tax on its items of income and loss. Instead, an S corporation passes through its items of income and loss to its shareholders. Each shareholder takes into account separately his or her pro rata share of these items on their individual income tax returns. To prevent double taxation of these items, each shareholder's basis in the stock of the S corporation is increased by the amount included in income (including tax-exempt income) and is decreased by the amount of any losses (including nondeductible losses) taken into account. A shareholder may deduct losses only to the extent of a shareholder's basis in his or her stock in the S corporation plus the shareholder's adjusted basis in any indebtedness of the corporation to the shareholder. Any loss that is disallowed by reason of lack of basis is "suspended" at the corporate level and is carried forward and allowed in any subsequent year in which the shareholder has adequate basis in the stock or debt.

In general, gross income includes income from the discharge of indebtedness. However, income from the discharge of indebtedness of a taxpayer in a bankruptcy case or when the taxpayer is insolvent (to the extent of the insolvency) is excludable from income. The taxpayer is required to reduce tax attributes, such as net operating losses, certain carryovers, and basis in assets, to the extent of the excluded income. In the case of an S corporation, the eligibility for the exclusion and the attribute reduction are applied at the corporate level. For this purpose, a shareholder's suspended loss is treated as a tax attribute that is reduced. Thus, if the S corporation is in bankruptcy or is insolvent, any income from the discharge of indebtedness by a creditor of the S corporation is excludable from the corporation's income, and the S corporation reduces its tax attributes (including any suspended losses) to the extent of such exclusion.

To illustrate these rules, assume that a sole shareholder of an S corporation has zero basis in its stock of the corporation. The S corporation borrows $100 from a third party and loses the entire $100. Because the shareholder has no basis in its stock, the $100 loss is "suspended" at the corporate level. If the $100 debt is forgiven when the corporation is in bankruptcy or is insolvent, the $100 income from the discharge of indebtedness is excluded from income, and the $100 "suspended" loss should be eliminated in order to achieve a tax result that is consistent with the economics of the transactions in that the shareholder has no economic gain or loss from these transactions.

Notwithstanding the economics of the overall transaction, the United States Supreme Court ruled in the case of *Gitlitz v. Commissioner* that, under present law, income from the discharge of indebtedness of an S corporation that is excluded from income is treated as an item of income which increases the basis of a shareholder's stock in the S corporation and allows the suspended corporate loss to pass thru to a shareholder. Thus, under the decision, an S corporation shareholder is allowed to deduct a loss for tax purposes that it did not economically incur.

Explanation of the Job Creation Act of 2002 Provision

The Job Creation Act of 2002 provided that income from the discharge of indebtedness of an S corporation that is excluded from the S corporation's income is not taken into account as an item of income by any shareholder and thus does not increase the basis of any shareholder's stock in the corporation. The federal effective date of the provision generally applies to discharges of indebtedness after October 11, 2001. The provision does not apply to any discharge of indebtedness before March 1, 2002, pursuant to a plan of reorganization filed with a bankruptcy court on or before October 11, 2001.

CALIFORNIA LAW

California law is in conformity with federal as it relates to the discharge of indebtedness of an S corporation as it read January 1, 1998. California has not conformed to the Job Creation Act of 2002 provision that affects discharge of indebtedness of an S corporation.

THIS BILL

This bill would conform to the Job Creation Act of 2002 change to the discharge of indebtedness of an S corporation. This provision would apply for California purposes to discharges of indebtedness after December 31, 2001, in taxable years ending after that date. The provision would not apply to any discharge of indebtedness before March 1, 2002, pursuant to a plan of reorganization filed with a bankruptcy court on or before October 11, 2001.

LEGISLATIVE HISTORY

This provision is also contained in AB 1122 (Corbett, 2002). AB 1122 is in enrollment.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws. The provision was enacted into federal law on March 9, 2002, therefore; only those states that automatically conform to the IRC (*Illinois, Michigan, and New York)* are in conformity with this provision.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Estimated Conformity Impact of SB 657			
4/25/02			
Fiscal Years			
(In Millions)			
Provision	2002-3	2003-4	2004-5
Sub S discharge of indebtedness	$2	$3	$3

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion:

Estimates for this proposal are based on original federal projections in the Estimated Revenue Effects of the "Job Creation and Worker Assistance Act of 2002" reflecting a January 1, 2002, effective date for California tax purposes. The revenue implication in not applying the October 11, 2001, federal starting date is minor, less than $500,000.

6. CONFORMITY TO THE DENIAL OF CLUB MEMBERSHIP DUES DEDUCTION

Under federal law, prior to 1993, and current state law, a deduction for club dues was allowable if the taxpayer could establish that the use of the club was primarily for the furtherance of the taxpayer's trade or business and the specific expense was directly related to the active conduct of a trade or business.

In 1990, California limited the deduction for club dues by denying the deduction for any amounts paid to any club that has discriminatory practices. No expense made at or paid to a club that restricts membership or the use of services or its facilities based on age, sex, race, religion, color, ancestry, or national origin is deductible.

The federal Revenue Reconciliation Act of 1993 (RRA of 1993) provided that no deduction is permitted for club dues. The prohibition applies to all types of clubs, including business, social, athletic, luncheon, and sporting clubs. Specific business expenses (e.g., meals) incurred at the club are deductible only to the extent they are directly related to the active conduct of the taxpayer's trade or business.

California has not conformed to the 1993 federal change.

THIS BILL

Beginning in the 2002 taxable year this bill would conform California law to the RRA of 1993 change denying the deduction for club dues.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws. The review of these states' tax laws indicates that they do not permit the deduction of club dues.

LEGISLATIVE HISTORY

This provision of the bill is also in AB 1122 (Corbett, 2002). AB 1122 is in enrollment. This provision has not been introduced into a bill since 1995.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Estimated Conformity Impact of SB 657			
4/25/02			
Fiscal Years			
(In Millions)			
Provision	2002-3	2003-4	2004-5
Club Dues	$12	$9	$10

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion:

The projected impact of this proposal is based on full conformity, i.e., no deduction for club dues, commencing with taxable years beginning on or after January 1, 2002.

7. DEDUCTION OF EXCESS COMPENSATION FOR OFFICERS

Generally, for federal and state purposes, an employer is allowed a deduction for reasonable salaries and other compensation. Whether compensation is reasonable is determined on a case-by-case basis. The reasonableness standard has been used primarily to limit payments by closely-held companies where dividends may be disguised as deductible compensation.

In 1993, federal law capped the maximum amount of salaries paid to certain executives that a publicly held corporation could deduct. Under the RRA of 1993, for purposes of the regular income tax and the alternative minimum tax, the otherwise allowable deduction for compensation paid or accrued with respect to a covered employee (defined below) of a publicly held corporation is limited to no more than $1 million per year.

Definition of publicly held corporation

For purposes of this provision, a corporation is publicly held if it is required to register under the Securities Exchange Act of 1934. In general, the Securities Exchange Act requires a corporation to register if: (1) the corporation's stock is listed on a national securities exchange or (2) the corporation has $5 million or more of assets and 500 or more shareholders. A corporation is not considered publicly held under the provision if registration of its equity securities is voluntary.

Covered employees

For purposes of this provision, a covered employee is defined by reference to the Securities and Exchange Commission (SEC) rules governing disclosure of executive compensation. A person is a covered employee if (1) the employee is the chief executive officer of the corporation (or an individual acting in such capacity) as of the close of the taxable year or (2) the employee's total compensation is required to be reported for the taxable year under the Securities Exchange Act of 1934 because the employee is one of the four highest compensated officers for the taxable year (other than the chief executive officer).

Compensation subject to the deduction limitation

In general

Unless specifically excluded, the deduction limitation applies to all remuneration for services, including cash and the cash value of all remuneration (including benefits) paid in a medium other than cash. If an individual is a covered employee for a taxable year, the deduction limitation applies to all compensation not explicitly excluded from the deduction limitation, regardless of whether the compensation is for services as a covered employee and regardless of when the compensation was earned. The $1 million cap is reduced by excess parachute payments (as defined in Sec. 280G) that are not deductible by the corporation.

The deduction limitation applies when the deduction would otherwise be taken. Thus, for example, in the case of a nonqualified stock option, the deduction is normally taken in the year the option is exercised, even though the option was granted with respect to services performed in a prior year.

Certain types of compensation are not subject to the deduction limit and are not taken into account in determining whether other compensation exceeds $1 million. The following types of compensation are not taken into account: (1) remuneration payable on a commission basis; (2) remuneration payable solely on account of the attainment of one or more performance goals if certain outside director and shareholder approval requirements are met; (3) payments to a tax-qualified retirement plan (including salary reduction contributions); (4) amounts that are excludable from the executive's gross income (such as employer provided health benefits and miscellaneous fringe benefits (Sec. 132)); and (5) any remuneration payable under a written binding contract which was in effect on February 17, 1993, and all times thereafter before such remuneration was paid and which was not modified thereafter in any material respect before such remuneration was paid.

Commissions

In order to qualify for the exception for compensation paid in the form of commissions, the commission must be payable solely on account of income generated directly by the individual performance of the executive receiving such compensation. Thus, for example, compensation that equals a percentage of sales made by the executive qualifies for the exception. Remuneration does not fail to be attributable directly to the executive merely because the executive utilizes support services, such as secretarial or research services, in generating the income. However, if compensation is paid on account of broader performance standards, such as income produced by a business unit of the corporation, the compensation would not qualify for the exception because it is not paid with regard to income that is directly attributable to the individual executive.

Other performance-based compensation

In general. ----Compensation qualifies for the exception for performance-based compensation only if (1) it is paid solely on account of the attainment of one or more performance goals, (2) the performance goals are established by a compensation committee consisting solely of two or more outside directors, (3) the material terms under which the compensation is to be paid, including the performance goals, are disclosed to and approved by the shareholders in a separate vote prior to payment, and (4) prior to payment, the compensation committee certifies that the performance goals and any other material terms were in fact satisfied. Treasury regulations contain detail rules and examples of performance-based compensation that qualifies for the exception,

Compensation payable under a written binding contract. -- Remuneration payable under a written binding contract which was in effect on February 17, 1993, and at all times thereafter is not subject to the deduction limitation. The fact that a plan was in existence on February 17, 1993, is not by itself sufficient to qualify the plan for the exception for binding written contracts. This exception ceases to apply if the contract was materially modified or renewed.

THIS BILL

This bill would conform state law to federal law and deny the deduction of excess compensation for officers of a publicly-held company. The conformity is accomplished by amending the Corporation Tax Law to reference the Internal Revenue Code, and, therefore, compensation paid under a binding written contract in effect on or before February 17, 1993, will not be subject to this limitation.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws. The review of these states' tax laws indicates that they do not permit the deduction of compensation to certain executives in excess of $1 million.

LEGISLATIVE HISTORY

This provision of the bill is also in AB 1122 (Corbett, 2002). AB 1122 is in enrollment. This provision has not been introduced into a bill since 1995.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Estimated Conformity Impact of SB 657			
4/25/02			
Fiscal Years			
(In Millions)			
Provision	2002-3	2003-4	2004-5
Executive Compensation	$4	$4	$5

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Estimates for this proposal are based on original federal projections in the Revenue Reconciliation Act of 1993, adjusted to account for current business trends.

8. DISALLOW LOBBYING AND POLITICAL EXPENSES

Current state and federal laws generally allow a taxpayer engaged in a trade or business to deduct all expenses that are considered ordinary and necessary in conducting that trade or business.

Under current state law, the costs of representing a taxpayer's views on matters of direct interest to his or her business to individual legislators, and the costs of communicating with an organization regarding legislation, are explicitly allowed as deductible business expenses. The portion of dues relating to lobbying activities performed by an organization also may be deducted. However, a taxpayer is prohibited from deducting any expenses incurred to influence the vote of the public or to participate in political campaigns. Under current federal law, none of these costs are deductible.

THIS BILL

This bill would conform state law to federal law. This bill would specify that deductible business expenses would not include costs incurred by a taxpayer to lobby the state Legislature, Congress, and certain executive branch officials.

LEGISLATIVE HISTORY

SB 964 (Hayden, 1993/1994) would have denied a deduction for certain lobbying and political expenses, but failed passage from the Senate Revenue and Taxation Committee.

AB 72 (Klehs and Bustamante, Stats. 1994, Ch. 851) would have denied a deduction for certain lobbying and political expenses, but the language regarding that deduction was eliminated from the bill in the January 14, 1994, amendment.

AB 1865 (Isenberg, et al., 1993/1994) would have denied a deduction for certain lobbying and political expenses, but failed passage from the Assembly Revenue and Taxation Committee.

AB 1122 (Corbett, 2002) contains the same provision as this bill. AB 1122 is in enrollment.

SB 1724 (Speier, 2002) would deny the deduction for certain lobbying and political expenses. SB 1724 is in the Senate Revenue and Taxation Committee.

OTHER STATES' INFORMATION

Florida, Illinois, Massachusetts, Michigan, Minnesota, and *New York* laws do not currently appear to permit the deduction for certain lobbying and political expenses. The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Based on the data and assumptions below, order of magnitude revenue effects are estimated as follows:

Estimated Revenue Impact of SB 657			
4/25/02			
Fiscal Years			
(In Millions)			
	2002/2003	2003/2004	2004/2005
Lobbying Expense	$7	$7	$7

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion

This revenue estimate is based on the Joint Committee of Taxation estimate made for the same provision in the federal Revenue Reconciliation Act of 1993, prorated for California purposes and grown to 2002 and beyond.

9. CONFORMITY TO FEDERAL ESTIMATED PAYMENT REQUIREMENTS

Under federal law, an individual taxpayer generally is subject to an addition to tax for any underpayment of estimated tax. Income tax withholding from wages is considered to be a payment of estimated taxes. An individual generally does not have an underpayment of estimated tax if the required estimated tax for the year is less than $1,000 or if he or she makes timely estimated tax payments (required payments) at least equal to:

1) 90% of the tax shown on the return for the current year, or

2) 100% of the tax shown on the return of the individual for the preceding year. A special rule affecting high-income taxpayers with AGI over $150,000 ($75,000 if married filing a separate return) applies. Effective for 2002, federal law requires high-income taxpayers with AGI in excess of $150,000 to make payments of 112% of the individual's tax for the preceding year. For 2003 and thereafter, the percentage is 110%.

For estimated tax purposes, some trusts and estates are treated as individuals.

CALIFORNIA LAW

Current California law conforms, in general, with federal rules relating to the payment of estimated tax by individuals. However, there are several significant differences:

- The "required payment" is based upon 80% of the current year tax instead of the federal 90%.
- The "required payment" does not include alternative minimum tax.
- Estimated payments are required, unless the tax due for the year is less than $200 as opposed to the federal $1,000.
- No penalty will be assessed if 80% of the current or prior year tax is subject to withholding.
- No penalty will be assessed if 80% of the AGI consists of items subject to withholding.
- The safe harbor percentage for high-income taxpayers is 110% for 2002 and thereafter.

THIS BILL

This bill would require alternative minimum tax to be included in the computation of required estimated tax payments, eliminate the two 80% subject to withholding safe harbors and conform to the federal 90% of the current year tax liability safe harbor. California is already conformed to the preceding year safe harbor. This bill would not conform to the federal $1,000 de minimis safe harbor but instead would retain the state $200 de minimis safe harbor.

Additionally, this bill would waive additions to tax imposed for any underpayments of tax or estimated tax for any period before April 15, 2003, with respect to any underpayment for the 2002 taxable year to the extent the underpayment was created or increased by any provision of this bill.

LEGISLATIVE HISTORY

AB 1122 (Corbett, 2002) contains the same provision as this bill. AB 1122 is in enrollment.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws. *New York* conforms to the federal estimates requirements except that a $300 de minimis safe harbor applies. *Illinois, Michigan, and Minnesota* generally conforms to federal law except that taxpayers with AGI greater than $150,000 do not have special requirements. *Michigan* also has a $500 de minimis safe harbor. *Massachusetts* conforms to federal except that 80% of current year tax liability safe harbor applies. *Florida* does not have a personal income tax.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Estimated Conformity Impact of SB 657			
4/25/02			
Fiscal Years			
(In Millions)			
Provision	2002-3	2003-4	2004-5
Federal Estimate Payment Requirements	$210	$10	$10
Waive Estimated Tax Penalties	No Impact	No Impact	No Impact

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion

The impact of the above changes in the required estimated payments is simulated for each PIT taxpayer in a large sample of PIT taxpayers for the 1999 tax year. These simulations take into account specific micro-economic data for each PIT taxpayer such as adjusted gross income, wage, estimated payments, credit, AMT, and other detailed tax data. The results of the simulations are weighted statistically to the population level. The revenue acceleration is estimated as the differences between the timing of tax payments simulated under current and proposed laws.

The DOF's forecast of taxable income was used to extrapolate the estimated result for 1999 to future years. The much larger acceleration for 2002-3 reflects additional payments of current law liabilities over the first half of the 2003 tax year, which would have occurred in 2003-4 under existing estimated tax requirements.

10. CONFORMITY TO THE 1998, 1999, AND 2000 FEDERAL CHANGES

The Personal Income Tax Law (PITL) and the Corporation Tax Law (CTL), in general, conform to the Internal Revenue Code (IRC or Code) either by incorporating the IRC by reference as of a "specified date" or by stand-alone language that mirrors the federal provision. California law is conformed to the IRC as of January 1, 1998, unless a specific provision provides otherwise. This bill would change the specified date from January 1, 1998, to January 1, 2001, for taxable years beginning on or after January 1, 2002. Changing the specified date automatically conforms to all changes from January 1, 1998, through December 31, 2000, to IRC sections that have been previously incorporated by reference. Thus, California law would conform to numerous changes made to federal income tax law since 1998 by the six federal bills that have been enacted into law during that time that materially affect the IRC. They are:

- IRS RESTRUCTURING AND REFORM ACT OF 1998 (IRS Reform Act)
- TAX AND TRADE RELIEF EXTENSION ACT OF 1998 (Tax and Trade Extension Act)
- SURFACE TRANSPORTATION REVENUE ACT 1998 (Transportation Act)
- RICKY RAY HEMOPHILIA RELIEF FUND ACT OF 1998 (Ricky Ray Hemophilia Act)
- TICKET TO WORK AND WORK INCENTIVES IMPROVEMENT ACT OF 1999 (Ticket to Work Act)
- MISCELLANEOUS TRADE AND TECHNICAL CORRECTIONS ACT OF 1999 (Miscellaneous Trade Act)
- CONSOLIDATED APPROPRIATIONS ACT, 2001 (Appropriations Act, 2001, enacted in December of 2000)

This bill would also conform to the technical corrections contained in the Job Creation Act of 2002 to the extent that the corrections are to federal provisions that are specially conformed to by reference.

This bill also would make numerous changes to specifically not conform to particular federal provisions or to modify the general conformity to certain items in the IRC.

The following is a list of the changes that would be made to California tax law by this bill. For a complete analysis of each item, refer to the corresponding page number below in Appendix II[2].

[2] Information for Appendix II derived from the Joint Committee on Taxation reports.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

SB 657
4/25/02
1998- 2000 Conformity Revenue Estimates

	Provisions		Personal Income Tax (in millions)			Corporation Tax (in millions)		
			2002-03	2003-04	2004-05	2002-03	2003-04	2004-05
	Conformity Items							
1	Exclusion from Income for Employer-Provided Transportation Benefits		Insignificant	Insignificant	Insignificant	Insignificant	Insignificant	Insignificant
2	Exclusion of value of meals to employees		-$1	-$1	-$1	-	-	-
3	Employer Deductions for Vacation and Severance Pay	a/	Minor Gain	Minor Gain	Minor Gain	$2	$3	$3
4	Certain Trade Receivables Ineligible for Mark-To-Market Treatment		Minor Gain	Minor Gain	Minor Gain	$12	$18	$10
5	Exclusion-Min. Req. Distributions from AGI for Roth IRA Conversions	b/	-	-	-	-	-	-
6	Farm Production Flexibility Contract Payments		Insignificant	Insignificant	Insignificant	Insignificant	Insignificant	Insignificant
7	Certain Deductible Liquidating Distributions of RICs & REITs	c/	-	-	-	$5	$5	$5
8	Tax Treatment of Cash Options for Qualified Prizes		Minor Loss	Minor Loss	Minor Loss	-	-	-
9	Payments Received Pursuant to the Ricky Ray Hemophilia Relief Fund Act		Insignificant	Insignificant	Insignificant	-	-	-
10	Property Subject to a Liability Treated as Assumption of Liability - P.L. 106-36		-	-	-	$1	$1.5	$1.5
11	Extend Tentative Minimum Tax Relief for Individuals		Negl. Loss	Negl. Loss	Negl. Loss	-	-	-
12	Extend/Expand Expensing of Environmental Remediation Expenditures.	d/	Negl. Loss	Negl. Loss	Negl. Loss	-$10	-$6	-$2
13	Provide that Federal Production Payments to Farmers are Taxable in the Year Received		Negl. Impact	Negl. Impact	Negl. Impact	Negl. Impact	Negl. Impact	Negl. Impact
14	Clarify the Tax Treatment of Income and Losses from Derivatives		Negl. Gain	Negl. Gain	Negl. Gain	Negl. Gain	Negl. Gain	Negl. Gain
15	Expand Reporting of Cancellation of Indebtedness Income		-	-	-	Negl. Gain	Negl. Gain	Negl. Gain
16	Limit conversion of Character of Income from Constructive Ownership Transactions		$1	$1	$1	Negl. Gain	Negl. Gain	Negl. Gain
17	Treatment of Excess Pension Assets Used for Retiree Health Benefits	e/	-	-	-	-	-	-

18	Installment Method Pledge Rules	f/	-	-	-	-	-	-
19	Denial of Charitable Contribution Deduction for Transfers Associated with Split-Dollar Insurance Arrangements		Negl. Gain	Negl. Gain	Negl. Gain	Negl. Gain	Negl. Gain	Negl. Gain
20	Distributions by a Partnership to a Corporate Partner of Stock in Another Corporation		-	-	-	Minor Gain	Minor Gain	Minor Gain
21	Low Income Housing Credit	g/	-	-	-	No Impact	No Impact	No Impact
22	Corporate Donations of Computers		-	-	-	-$6	-$2	Insignificant
23	Medical Savings Accounts		Negl. Loss	Negl. Loss	Negl. Loss	Negl. Loss	Negl. Loss	Negl. Loss
24	Tax Benefits - Kidnapped Children		Negl. Loss	Negl. Loss	Negl. Loss	-	-	-
25	Assumption of Liabilities - Corporations - P.L. 106-554		-	-	-	$1	$0.5	$1
26	Tax Treatment of Securities Futures Contracts		-	-	-	Negl. Impact	Negl. Impact	Negl. Impact
27	Tax Technical Corrections		Negl. Impact	Negl. Impact	Negl. Impact	Negl. Impact	Negl. Impact	Negl. Impact
28	1999 Federal Technical Changes		Insignificant	Insignificant	Insignificant	Insignificant	Insignificant	Insignificant
	TOTALS		-	-	-	$5	$20.0	$18.5

Footnotes.

Negligible = Loss or gain of less than $250,000

Minor = Loss or gain of less than $500,000

a/ Baseline revenue gains are projected to be $3 million annually.

b/ Conformity gains are estimated to be $1 million annually beginning with the fiscal year 2004-5.
Baseline revenue gains are projected to be $84 million for 2004-5, $101 million for 2005-6, and $99 million for 2006-7.

c/ Baseline revenue gains are projected to be $15 million annually.

d/ Includes conformity impact for 2002 and 2003.

e/ Baseline gains from reduced business deductions are estimated at $1 million annually in 2001-2 thru 2004-5.

f/ Baseline revenue gains are projected to be $1 million annually.

g/ The California Tax Allocation Committee already allocates the maximum credit authorizations.

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Appendix I
Conformity to EGTRRA
SB 657 (Scott)

Section	Section Title
401	MODIFICATIONS TO EDUCATION IRAs.

Background

In general

Section 530 of the Internal Revenue Code provides tax-exempt status to education individual retirement accounts ("education IRAs"), meaning certain trusts or custodial accounts which are created or organized in the United States exclusively for the purpose of paying the qualified higher education expenses of a designated beneficiary. Contributions to education IRAs may be made only in cash. Special estate and gift tax rules apply to contributions made to and distributions made from education IRAs.

Annual contributions to education IRAs may not exceed $500 per beneficiary (except in cases involving certain tax-free rollovers, as described below) and may not be made after the designated beneficiary reaches age 18. Specially, IRC Section 530 states that an education IRA is a trust, which among other things cannot accept contributions that would result in aggregate contributions for the taxable year to exceed $500.

Phase-out of contribution limit

The $500 annual contribution limit for education IRAs is generally phased-out ratably for contributors with modified AGI (between $95,000 and $110,000). The phase-out range for married taxpayers filing a joint return is $150,000 to $160,000 of modified AGI. Individuals with modified AGI above the phase-out range are not allowed to make contributions to an education IRA established on behalf of any individual.

Treatment of distributions

Earnings on contributions to an education IRA generally are subject to tax when withdrawn. However, distributions from an education IRA are excludable from the gross income of the beneficiary to the extent that the distribution does not exceed the "qualified higher education expenses" incurred by the beneficiary during the year the distribution is made.

If the qualified higher education expenses of the beneficiary for the year are less than the total amount of the distribution (i.e., contributions and earnings combined) from an education IRA, then the qualified higher education expenses are deemed to be paid from a pro-rata share of both the principal and earnings components of the distribution. Thus, in such a case, only a portion of the earnings is excludable (i.e., the portion of the earnings based on the ratio that the qualified higher education expenses bear to the total amount of the distribution) and the remaining portion of the earnings is includible in the beneficiary's gross income.

The earnings portion of a distribution from an education IRA that is includible in income is also subject to an additional 10% tax. The 10% additional tax does not apply if a distribution is made on account of the death or disability of the designated beneficiary, or on account of a scholarship received by the designated beneficiary. The additional 10% tax also does not apply to the distribution of any contribution to an education IRA made

during the taxable year if such distribution is made on or before the date that a return is required to be filed (including extensions of time) by the beneficiary for the taxable year during which the contribution was made (or, if the beneficiary is not required to file such a return, April 15th of the year following the taxable year during which the contribution was made).

Present law allows tax-free transfers or rollovers of account balances from one education IRA benefiting one beneficiary to another education IRA benefiting another beneficiary (as well as redesignations of the named beneficiary), provided that the new beneficiary is a member of the family of the old beneficiary and is under age 30.

Any balance remaining in an education IRA is deemed to be distributed within 30 days after the date that the beneficiary reaches age 30 (or, if earlier, within 30 days of the date that the beneficiary dies).

Qualified higher education expenses

The term ”qualified higher education expenses” includes tuition, fees, books, supplies, and equipment required for the enrollment or attendance of the designated beneficiary at an eligible education institution, regardless of whether the beneficiary is enrolled at an eligible educational institution on a full-time, half time, or less than half-time basis. Qualified higher education expenses include expenses with respect to undergraduate or graduate-level courses. In addition, qualified higher education expenses include amounts paid or incurred to purchase tuition credits (or to make contributions to an account) under a qualified state tuition program, as defined in section 529, for the benefit of the beneficiary of the education IRA. Moreover, qualified higher education expenses include, within limits, room and board expenses for any academic period during which the beneficiary is at least a half-time student. Room and board expenses that may be treated as qualified higher education expenses are limited to the minimum room and board allowance applicable to the student in calculating costs of attendance for federal financial aid programs under section 472 of the Higher Education Act of 1965, as in effect on the date of enactment of the Small Business Job Protection Act of 1996 (August 20, 1996). Thus, room and board expenses cannot exceed the following amounts: (1) for a student living at home with parents or guardians, $1,500 per academic year; (2) for a student living in housing owned or operated by the eligible education institution, the institution's “normal” room and board charge; and (3) for all other students, $2,500 per academic year.

Qualified higher education expenses generally include only out-of-pocket expenses. Such qualified higher education expenses do not include expenses covered by educational assistance for the benefit of the beneficiary that is excludable from gross income. Thus, total qualified higher education expenses are reduced by scholarship or fellowship grants excludable from gross income under present-law section 117, as well as any other tax-free educational benefits, such as employer-provided educational assistance that is excludable from the employee's gross income under section 127.

Present law also provides that if any qualified higher education expenses are taken into account in determining the amount of the exclusion for a distribution from an education IRA, then no deduction (e.g., for trade or business expenses), exclusion (e.g., for interest on education savings bonds) or credit is allowed with respect to such expenses.

Eligible educational institutions are defined by reference to section 481 of the Higher Education Act of 1965. Such institutions generally are accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, a graduate-level or professional degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also are eligible institutions. The institution must be eligible to participate in Department of Education student aid programs.

Time for making contributions

Contributions to an education IRA for a taxable year are taken into account in the taxable year in which they are made.

Coordination with HOPE and Lifetime Learning credits

If an exclusion from gross income is allowed for distributions from an education IRA with respect to an individual, then neither the HOPE nor Lifetime Learning credit may be claimed in the same taxable year with respect to the same individual. However, an individual may elect to waive the exclusion with respect to distributions from an education IRA. If such a waiver is made, then the HOPE or Lifetime Learning credit may be claimed with respect to the individual for the taxable year.

Coordination with qualified tuition programs

An excise tax is imposed on contributions to an education IRA for a year if contributions are made by anyone to a qualified state tuition program on behalf of the same beneficiary in the same year. The excise tax is equal to 6% of the contributions to the education IRA. The excise tax is imposed each year after the contribution is made, unless the contributions are withdrawn.

New Federal Law (IRC. Sec. 530)

Annual contribution

EGTRRA increases the annual limit on contributions to education IRAs from $500 to $2,000. Thus, aggregate contributions that may be made by all contributors to one (or more) education IRAs established on behalf of any particular beneficiary is limited to $2,000 for each year.

Qualified education expenses

EGTRRA expands the definition of qualified education expenses that may be paid tax-free from an education IRA to include “qualified elementary and secondary school expenses,” meaning expenses for (1) tuition, fees, academic tutoring, special need services, books, supplies, and other equipment incurred in connection with the enrollment or attendance of the beneficiary at a public, private, or religious school providing elementary or secondary education (kindergarten through grade 12) as determined under state law, (2) room and board, uniforms, transportation, and supplementary items or services (including extended day programs) required or provided by such a school in connection with such enrollment or attendance of the beneficiary, and (3) the purchase of any computer technology or equipment (as defined in sec. 170(e)(6)(F)(i)) or Internet access and related services, if such technology, equipment, or services are to be used by the beneficiary and the beneficiary's family during any of the years the beneficiary is in school. Computer software primarily involving sports, games, or hobbies is not considered a qualified elementary and secondary school expense unless the software is predominantly educational in nature.

Phase-out of contribution limit

EGTRRA increases the phase-out range for married taxpayers filing a joint return so that it is twice the range for single taxpayers. Thus, the phase-out range for married taxpayers filing a joint return is $190,000 to $220,000 of modified AGI.

Special needs beneficiaries

EGTRRA provides that the rule prohibiting contributions to an education IRA after the beneficiary attains 18 does not apply in the case of a special needs beneficiary (as defined by Treasury Department regulations). In addition, a deemed distribution of any balance in an education IRA does not occur when a special needs beneficiary reaches age 30. Finally, the age 30 limitation does not apply in the case of a rollover contribution for the benefit of a special needs beneficiary or a change in beneficiaries to a special needs beneficiary. Treasury regulations are to define a special needs beneficiary to include an individual who because of a physical, mental, or emotional condition (including learning disability) requires additional time to complete his or her education.

Contributions by persons other than individuals

EGTRRA clarifies that corporations and other entities (including tax-exempt organizations) are permitted to make contributions to education IRAs, regardless of the income of the corporation or entity during the year of the contribution.

Contributions permitted until April 15

Under EGTRRA, individual contributors to education IRAs are deemed to have made a contribution on the last day of the preceding taxable year if the contribution is made on account of such taxable year and is made not later than the time prescribed by law for filing the individual's federal income tax return for such taxable year (not including extensions). Thus, individual contributors generally may make contributions for a year until April 15 of the following year.

Qualified room and board expenses

EGTRRA modifies the definition of room and board expenses considered to be qualified higher education expenses. This modification is described with the provisions relating to qualified tuition programs, below.

Coordination with HOPE and Lifetime Learning credits

EGTRRA allows a taxpayer to claim a HOPE credit or Lifetime Learning credit for a taxable year and to exclude from gross income amounts distributed (both the contributions and the earnings portions) from an education IRA on behalf of the same student as long as the distribution is not used for the same educational expenses for which a credit was claimed.

Coordination with qualified tuition programs

EGTRRA repeals the excise tax on contributions made by any person to an education IRA on behalf of a beneficiary during any taxable year in which any contributions are made by anyone to a qualified state tuition program on behalf of the same beneficiary. If distributions from education IRAs and qualified tuition programs exceed the beneficiary's qualified higher education expenses for the year (after reduction by amounts used in claiming the HOPE or Lifetime Learning credit), the beneficiary is required to allocate the expenses between the distributions to determine the amount includible in income.

Effective Date

The provisions modifying education IRAs are effective for taxable years beginning after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to the definition of education IRAs. California law has not conformed to the changes made to the IRC by the EGTRRA.

Section	Section Title
402	PRIVATE PREPAID TUITION PROGRAMS; EXCLUSION FROM GROSS INCOME OF EDUCATION DISTRIBUTIONS FROM QUALIFIED TUITION PROGRAMS.

Background

Law prior to EGTRRA

Section 529 of the Code provides tax-exempt status to "qualified state tuition programs," meaning certain programs established and maintained by a state (or agency or instrumentality thereof) under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary, or (2) make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account (a "savings account plan"). The term "qualified higher education expenses" generally has the same meaning as does the term for purposes of education IRAs (as described above) and, thus, includes expenses for tuition, fees, books, supplies, and equipment required for the enrollment or attendance at an eligible educational institution, as well as certain room and board expenses for any period during which the student is at least a half-time student. An "eligible education institution" is defined the same for purposes of education IRAs (described above) and qualified state tuition programs.

No amount is included in the gross income of a contributor to, or a beneficiary of, a qualified state tuition program with respect to any distribution from, or earnings under, such program, except that (1) amounts distributed or educational benefits provided to a beneficiary are included in the beneficiary's gross income (unless excludable under another Code section) to the extent such amounts or the value of the educational benefits exceed contributions made on behalf of the beneficiary, and (2) amounts distributed to a contributor (e.g., when a parent receives a refund) are included in the contributor's gross income to the extent such amounts exceed contributions made on behalf of the beneficiary. Distributions from qualified state tuition programs are treated as representing a pro-rata share of the contributions and earnings in the account.

A qualified state tuition program is required to provide that purchases or contributions only be made in cash. Contributors and beneficiaries are not allowed to direct the investment of contributions to the program (or earnings thereon). The program is required to maintain a separate accounting for each designated beneficiary. A specified individual must be designated as the beneficiary at the commencement of participation in a qualified state tuition program (i.e., when contributions are first made to purchase an interest in such a program), unless interests in such a program are purchased by a state or local government or a tax-exempt charity described in section 501(c)(3) as part of a scholarship program operated by such government or charity under which beneficiaries to be named in the future will receive such interests as scholarships.

Special estate and gift tax rules apply to contributions made to and distributions made from qualified state tuition programs.

A transfer of credits (or other amounts) from one account benefiting one designated beneficiary to another account benefiting a different beneficiary is considered a distribution (as is a change in the designated beneficiary of an interest in a qualified state tuition program), unless the beneficiaries are members of the same family. For this purpose, the term "member of the family" means: (1) the spouse of the beneficiary; (2) a son or daughter of the beneficiary or a descendent of either; (3) a stepson or stepdaughter of the beneficiary; (4) a brother, sister, stepbrother or stepsister of the beneficiary; (5) the father or mother of the beneficiary or an ancestor of either; (6) a stepfather or stepmother of the beneficiary; (7) a son or daughter of a brother or sister of the beneficiary; (8) a brother or sister of the father or mother of the beneficiary; (9) a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law of the beneficiary; or (10) the spouse of any person described in (2)-(9). Earnings on an account may be refunded to a contributor or beneficiary, but the state or instrumentality must impose a more than de minimis monetary penalty unless the refund is (1) used for qualified higher education expenses of the beneficiary, (2) made on account of the death or disability of the beneficiary, (3) made on account of a scholarship received by the beneficiary, or (4) a rollover distribution.

To the extent that a distribution from a qualified state tuition program is used to pay for qualified tuition and related expenses (as defined in sec. 25A(f)(1)), the beneficiary (or another taxpayer claiming the beneficiary as a dependent) may claim the HOPE credit or Lifetime Learning credit with respect to such tuition and related expenses (assuming that the other requirements for claiming the HOPE credit or Lifetime Learning credit are satisfied and the modified AGI phase-out for those credits does not apply).

New Federal Law (IRC. Sec. 529)

Qualified tuition program

EGTRRA expands the definition of “qualified tuition program” to include certain prepaid tuition programs established and maintained by one or more eligible educational institutions (which may be private institutions) that satisfy the requirements under section 529 (other than the present-law state sponsorship rule). In the case of a qualified tuition program maintained by one or more private eligible educational institutions, persons are able to purchase tuition credits or certificates on behalf of a designated beneficiary (as set forth in sec. 529(b)(1)(A)(i)), but would not be able to make contributions to a savings account plan (as described in sec. 529(b)(1)(A)(ii)). Except to the extent provided in regulations, a tuition program maintained by a private institution is not treated as qualified unless it has received a ruling or determination from the IRS that the program satisfies applicable requirements.

EGTRRA provides that, in order for a tuition program of a private eligible education institution to be a qualified tuition program, assets of the program must be held in a trust created or organized in the United States for the exclusive benefit of designated beneficiaries that complies with the requirements under section 408(a)(2) and (5). Under these rules, the trustee must be a bank or other person who demonstrates that it will administer the trust in accordance with applicable requirements and the assets of the trust may not be commingled with other property except in a common trust fund or common investment fund.

EGTRRA repeals the present-law rule that a qualified state tuition program must impose a more than *de minimis* monetary penalty on any refund of earnings not used for qualified higher education expenses of the beneficiary (except in certain circumstances). Instead, EGTRRA imposes an additional 10% tax on the amount of a distribution from a qualified tuition plan that is includible in gross income (like the additional tax that applies to such distributions from education IRAs). The same exceptions that apply to the 10% additional tax with respect to education IRAs apply.

A special rule applies because the exclusion for earnings on distributions used for qualified higher education expenses does not apply to qualified tuition programs of private institutions until 2004. Under the special rule,

the additional 10% tax does not apply to any payment in a taxable year beginning before January 1, 2004, which is includible in gross income but used for qualified higher education expenses. Thus, for example, the earnings portion of a distribution from a qualified tuition program of a private institution that is made in 2003 and that is used for qualified higher education expenses is not subject to the additional tax, even though the earnings portion is includible in gross income. Conforming the penalty to the education IRA provisions will make it easier for taxpayers to allocate expenses between the various education tax incentives. For example, under EGTRRA, a taxpayer who receives distributions from an education IRA and a qualified tuition program in the same year is required to allocate qualified expenses in order to determine the amount excludable from income. Other interactions between the various provisions also arise under EGTRRA. For example, a taxpayer may need to know the amount excludable from income due to a distribution from a qualified tuition program in order to determine the amount of expenses eligible for the tuition deduction. It is expected that the Secretary will exercise the existing authority under sections 529(d) and 530(h) to require appropriate reporting, e.g., the amount of distributions and the earnings portions of distributions (taxable and nontaxable), to facilitate the provisions of EGTRRA.

Exclusion from gross income

Under EGTRRA, an exclusion from gross income is provided for distributions made in taxable years beginning after December 31, 2001, from qualified state tuition programs to the extent that the distribution is used to pay for qualified higher education expenses. This exclusion from gross income is extended to distributions from qualified tuition programs established and maintained by an entity other than a state (or agency or instrumentality thereof) for distributions made in taxable years after December 31, 2003.

Qualified higher education expenses

EGTRRA provides that, for purposes of the exclusion for distributions from qualified tuition plans, the maximum room and board allowance is the amount applicable to the student in calculating costs of attendance for federal financial aid programs under section 472 of the Higher Education Act of 1965, as in effect on June 7, 2001, or, in the case of a student living in housing owned or operated by an eligible educational institution, the actual amount charged the student by the educational institution for room and board. This definition also applies to distributions from education IRAs.

EGTRRA modifies the definition of qualified higher education expenses to include expenses of a special needs beneficiary that are necessary in connection with his or her enrollment or attendance at the eligible education institution. This definition also applies to distributions from education IRAs.
In addition, a special needs beneficiary would be defined as under the provisions relating to education IRAs, described above.

Coordination with HOPE and Lifetime Learning credits

EGTRRA allows a taxpayer to claim a HOPE credit or Lifetime Learning credit for a taxable year and to exclude from gross income amounts distributed (both the principal and the earnings portions) from a qualified tuition program on behalf of the same student as long as the distribution is not used for the same expenses for which a credit was claimed.

Rollovers for benefit of same beneficiary

EGTRRA provides that a transfer of credits (or other amounts) from one qualified tuition program for the benefit of a designated beneficiary to another qualified tuition program for the benefit of the same beneficiary is not considered a distribution. This rollover treatment does not apply to more than one transfer within any 12-month period with respect to the same beneficiary. The intent of this provision is to allow, for example, transfers between a prepaid tuition program and a savings program maintained by the same state and between a state plan and a private prepaid tuition program.

Member of family

EGTRRA provides that, for purposes of tax-free rollovers and changes of designated beneficiaries, a "member of the family" includes first cousins of the original beneficiary.

Effective Date

The provisions are effective for taxable years beginning after December 31, 2001, except that the exclusion from gross income for certain distributions from a qualified tuition program established and maintained by an entity other than a state (or agency or instrumentality thereof) is effective for taxable years beginning after December 31, 2003.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to qualified tuition programs. California law has not conformed to the changes made to the IRC by the EGTRRA.

Section	Section Title
601-603	INDIVIDUAL RETIREMENT ARRANGEMENT

Background

There are two general types of individual retirement arrangements ("IRAs") under present law: traditional IRAs, to which both deductible and nondeductible contributions may be made, and Roth IRAs. The federal income tax rules regarding each type of IRA (and IRA contribution) differ.

Traditional IRAs

Under present law, an individual may make deductible contributions to an IRA up to the lesser of $2,000 or the individual's compensation if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan. In the case of a married couple, deductible IRA contributions of up to $2,000 can be made for each spouse (including, for example, a homemaker who does not work outside the home), if the combined compensation of both spouses is at least equal to the contributed amount. If the individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the $2,000 deduction limit is phased out for taxpayers with AGI ("AGI") over certain levels for the taxable year.

The AGI phase-out limits for taxpayers who are active participants in employer-sponsored plans are as follows.

Single Taxpayers

Taxable years beginning in:	Phase-out range
2001	$33,000 43,000
2002	34,000 44,000
2003	40,000 50,000
2004	45,000 55,000
2005 and thereafter	50,000 60,000

Joint Returns

Taxable years beginning in:	Phase-out range
2001	$53,000 63,000
2002	54,000 64,000
2003	60,000 70,000
2004	65,000 75,000
2005	70,000 80,000
2006	75,000 85,000
2007 and thereafter	80,000 100,000

The AGI phase-out range for married taxpayers filing a separate return is $0 to $10,000.

If the individual is not an active participant in an employer-sponsored retirement plan, but the individual's spouse is, the $2,000 deduction limit is phased out for taxpayers with AGI between $150,000 and $160,000.

To the extent an individual cannot or does not make deductible contributions to an IRA or contributions to a Roth IRA, the individual may make nondeductible contributions to a traditional IRA.

Amounts held in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal is a return of nondeductible contributions). Includible amounts withdrawn prior to attainment of age 59 1/2 are subject to an additional 10% early withdrawal tax, unless the withdrawal is due to death or disability, is made in the form of certain periodic payments, is used to pay medical expenses in excess of 7.5% of AGI, is used to purchase health insurance of an unemployed individual, is used for education expenses, or is used for first-time homebuyer expenses of up to $10,000.

Roth IRAs

Individuals with AGI below certain levels may make nondeductible contributions to a Roth IRA. The maximum annual contribution that may be made to a Roth IRA is the lesser of $2,000 or the individual's compensation for the year. The contribution limit is reduced to the extent an individual makes contributions to any other IRA for the same taxable year. As under the rules relating to IRAs generally, a contribution of up to $2,000 for each spouse may be made to a Roth IRA provided the combined compensation of the spouses is at least equal to the contributed amount. The maximum annual contribution that can be made to a Roth IRA is phased out for single individuals with AGI between $95,000 and $110,000 and for joint filers with AGI between $150,000 and $160,000.

Taxpayers with modified AGI of $100,000 or less generally may convert a traditional IRA into a Roth IRA. The amount converted is includible in income as if a withdrawal had been made, except that the 10% early withdrawal tax does not apply and, if the conversion occurred in 1998, the income inclusion may be spread ratably over four years. Married taxpayers who file separate returns cannot convert a traditional IRA into a Roth IRA.

Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income, or subject to the additional 10% tax on early withdrawals. A qualified distribution is a distribution that (1) is made after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) which is made after attainment of age 59 1/2, on account of death or disability, or is made for first-time homebuyer expenses of up to $10,000.

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings, and subject to the 10% early withdrawal tax (unless an exception applies). The same exceptions to the early withdrawal tax that apply to IRAs apply to Roth IRAs. Early distribution of converted amounts may also accelerate income inclusion of converted amounts that are taxable under the four-year rule applicable to 1998 conversions.

New Federal Law (Sec. 219, 408, & 408A)

Increase in annual contribution limits

EGTRRA increases the maximum annual dollar contribution limit for IRA contributions from $2,000 to $3,000 for 2002 through 2004, $4,000 for 2005 through 2007, and $5,000 for 2008. After 2008, the limit is adjusted annually for inflation in $500 increments.

Additional catch-up contributions

EGTRRA provides that individuals who have attained age 50 may make additional catch-up IRA contributions. The otherwise maximum contribution limit (before application of the AGI phase-out limits) for an individual who has attained age 50 before the end of the taxable year is increased by $500 for 2002 through 2005, and $1,000 for 2006 and thereafter.

Deemed IRAs under employer plans

EGTRRA provides that, if an eligible retirement plan permits employees to make voluntary employee contributions to a separate account or annuity that (1) is established under the plan, and (2) meets the requirements applicable to either traditional IRAs or Roth IRAs, then the separate account or annuity is deemed a traditional IRA or a Roth IRA, as applicable, for all purposes of the Code. For example, the reporting requirements applicable to IRAs apply. The deemed IRA, and contributions thereto, are not subject to the Code rules pertaining to the eligible retirement plan. In addition, the deemed IRA, and contributions thereto, are not taken into account in applying such rules to any other contributions under the plan. The deemed IRA, and contributions thereto, are subject to the exclusive benefit and fiduciary rules of ERISA to the extent otherwise applicable to the plan, and are not subject to the ERISA reporting and disclosure, participation, vesting, funding, and enforcement requirements applicable to the eligible retirement plan. An eligible retirement plan is a qualified plan (sec. 401(a)), tax-sheltered annuity (sec. 403(b)), or a governmental section 457 plan.

EGTRRA does not specify the treatment of deemed IRAs for purposes other than the Code and ERISA.

Effective Date

The provisions are generally effective for taxable years beginning after December 31, 2001. The provision relating to deemed IRAs under employer plans is effective for plan years beginning after December 31, 2002.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to IRAs. California law has not conformed to the changes made to the IRC by the EGTRRA.

Section	Section Title
611	PENSION PROVISIONS - INCREASE IN BENEFIT AND CONTRIBUTION LIMITS.

Background

In general

Present law imposes limits on contributions and benefits under qualified plans (sec. 415), the amount of compensation that may be taken into account under a plan for determining benefits (sec. 401(a)(17)), the amount of elective deferrals that an individual may make to a salary reduction plan or tax sheltered annuity (sec. 402(g)), and deferrals under an eligible deferred compensation plan of a tax-exempt organization or a state or local government (sec. 457).

Limitations on contributions and benefits

Under present law, the limits on contributions and benefits under qualified plans are based on the type of plan. Under a defined contribution plan, the qualification rules limit the annual additions to the plan with respect to each plan participant to the lesser of (1) 25% of compensation or (2) $35,000 (for 2001). Annual additions are the sum of employer contributions, employee contributions, and forfeitures with respect to an individual under all defined contribution plans of the same employer. The $35,000 limit is indexed for cost-of-living adjustments in $5,000 increments. Under a defined benefit plan, the maximum annual benefit payable at retirement is generally the lesser of (1) 100% of average compensation, or (2) $140,000 (for 2001). The dollar limit is adjusted for cost-of-living increases in $5,000 increments. Under present law, in general, the dollar limit on annual benefits is reduced if benefits under the plan begin before the social security retirement age (currently, age 65) and increased if benefits begin after social security retirement age.

Compensation limitation

Under present law, the annual compensation of each participant that may be taken into account for purposes of determining contributions and benefits under a plan, applying the deduction rules, and for nondiscrimination testing purposes is limited to $170,000 (for 2001). The compensation limit is indexed for cost-of-living adjustments in $10,000 increments.

In general, contributions to qualified plans and IRAs are based on compensation. For a self-employed individual, compensation generally means net earnings subject to self-employment taxes (“SECA taxes”).

Members of certain religious faiths may elect to be exempt from SECA taxes on religious grounds. Because the net earnings of such individuals are not subject to SECA taxes, these individuals are considered to have no compensation on which to base contributions to a retirement plan. Under an exception to this rule, net earnings of such individuals are treated as compensation for purposes of making contributions to an IRA.

Elective deferral limitations

Under present law, under certain salary reduction arrangements, an employee may elect to have the employer make payments as contributions to a plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals.

The maximum annual amount of elective deferrals that an individual may make to a qualified cash or deferred arrangement (a "section 401(k) plan"), a tax-sheltered annuity ("section 403(b) annuity") or a salary reduction simplified employee pension plan ("SEP") is $10,500 (for 2001). The maximum annual amount of elective deferrals that an individual may make to a SIMPLE plan is $6,500 (for 2001). These limits are indexed for inflation in $500 increments.

Section 457 plans

The maximum annual deferral under a deferred compensation plan of a state or local government or a tax-exempt organization (a "section 457 plan") is the lesser of (1) $8,500 (for 2001) or (2) 33 1/3% of compensation. The $8,500 dollar limit is increased for inflation in $500 increments. Under a special catch-up rule, the section 457 plan may provide that, for one or more of the participant's last three years before retirement, the otherwise applicable limit is increased to the lesser of (1) $15,000 or (2) the sum of the otherwise applicable limit for the year plus the amount by which the limit applicable in preceding years of participation exceeded the deferrals for that year.

New Federal Law (Sec. 401(a)(17), 401(c)(2), 402(g), 408(p), 415 & 457)

Limits on contributions and benefits

EGTRRA increases the $35,000 limit on annual additions to a defined contribution plan to $40,000. This amount is indexed in $1,000 increments. EGTRRA increases the $140,000 annual benefit limit under a defined benefit plan to $160,000. The dollar limit is reduced for benefit commencement before age 62 and increased for benefit commencement after age 65. In adopting rules regarding the application of the increase in the defined benefit plan limits under EGTRRA, it is intended that the Secretary will apply rules similar to those adopted in Notice 99-44 regarding benefit increases due to the repeal of the combined plan limit under former section 415(e). Thus, for example, a defined benefit plan could provide for benefit increases to reflect the provisions of EGTRRA for a current or former employee who has commenced benefits under the plan prior to the effective date of the bill if the employee or former employee has an accrued benefit under the plan (other than an accrued benefit resulting from a benefit increase solely as a result of the increases in the section 415 limits under the bill). As under the notice, the maximum amount of permitted increase is generally the amount that could have been provided had the provisions of EGTRRA been in effect at the time of the commencement of benefit. In no case may benefits reflect increases that could not be paid prior to the effective date because of the limits in effect under present law. In addition, in no case may plan amendments providing increased benefits under the relevant provision of EGTRRA are effective prior to the effective date of EGTRRA. Another provision of EGTRRA modifies the defined benefit pension plan limits for multiemployer plans.

Compensation limitation

EGTRRA increases the limit on compensation that may be taken into account under a plan to $200,000. This amount is indexed in $5,000 increments. EGTRRA also amends the definition of compensation for purposes of all qualified plans and IRAs (including SIMPLE arrangements) to include an individual's net earnings that would be subject to SECA taxes but for the fact that the individual is covered by a religious exemption.

Elective deferral limitations

EGTRRA increases the dollar limit on annual elective deferrals under section 401(k) plans, section 403(b) annuities and salary reduction SEPs to $11,000 in 2002. In 2003 and thereafter, the limits are increased in $1,000 annual increments until the limits reach $15,000 in 2006, with indexing in $500 increments thereafter. EGTRRA increases the maximum annual elective deferrals that may be made to a SIMPLE plan to $7,000 in 2002. In 2003 and thereafter, the SIMPLE plan deferral limit is increased in $1,000 annual increments until the limit reaches $10,000 in 2005. Beginning after 2005, the $10,000 dollar limit is indexed in $500 increments.

Section 457 plans

EGTRRA increases the dollar limit on deferrals under a section 457 plan to conform to the elective deferral limitation. Thus, the limit is $11,000 in 2002, and is increased in $1,000 annual increments thereafter until the limit reaches $15,000 in 2006. The limit is indexed thereafter in $500 increments. The limit is twice the otherwise applicable dollar limit in the three years prior to retirement

Effective Date

The provisions are generally effective for years beginning after December 31, 2001. The provisions relating to defined benefit plans are effective for years ending after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to contribution limits of pensions. California law has not conformed to the changes made to the IRC by the EGTRRA.

Section	Section Title
612	PENSION PLAN - PLAN LOANS FOR S CORPORATION SHAREHOLDERS, PARTNERS, AND SOLE PROPRIETORS.

Background

The IRC prohibits certain transactions (“prohibited transactions”) between a qualified plan and a disqualified person in order to prevent persons with a close relationship to the qualified plan from using that relationship to the detriment of plan participants and beneficiaries. Certain types of transactions are exempted from the prohibited transaction rules, including loans from the plan-to-plan participants, if certain requirements are satisfied. In addition, the Secretary of Labor can grant an administrative exemption from the prohibited transaction rules if the Secretary finds the exemption is administratively feasible, in the interest of the plan and plan participants and beneficiaries, and protective of the rights of participants and beneficiaries of the plan.

Pursuant to this exemption process, the Secretary of Labor grants exemptions both with respect to specific transactions and classes of transactions.

The statutory exemptions to the prohibited transaction rules do not apply to certain transactions in which the plan makes a loan to an owner-employee. Certain transactions involving a plan and S corporation shareholders are permitted. Loans to participants other than owner-employees are permitted if loans are available to all participants on a reasonably equivalent basis, are not made available to highly compensated employees in an amount greater than made available to other employees, are made in accordance with specific provisions in the plan, bear a reasonable rate of interest, and are adequately secured. In addition, the Code places limits on the amount of loans and repayment terms.

For purposes of the prohibited transaction rules, an owner-employee means (1) a sole proprietor, (2) a partner who owns more than 10% of either the capital interest or the profits interest in the partnership, (3) an employee or officer of a Subchapter S corporation who owns more than 5% of the outstanding stock of the corporation, and (4) the owner of an individual retirement arrangement ("IRA"). The term owner-employee also includes certain family members of an owner-employee and certain corporations owned by an owner-employee.

Under the Internal Revenue Code, a two-tier excise tax is imposed on disqualified persons who engage in a prohibited transaction. The first level tax is equal to 15% of the amount involved in the transaction. The second level tax is imposed if the prohibited transaction is not corrected within a certain period, and is equal to 100% of the amount involved.

New Federal Law (Sec. 4975)

EGTRRA generally eliminates the special present-law rules relating to plan loans made to an owner-employee (other than the owner of an IRA). Thus, the general statutory exemption applies to such transactions. Present law continues to apply with respect to IRAs.

Congress intends that the Secretary of the Treasury and the Secretary of Labor will waive any penalty or excise tax in situations where a loan made prior to the effective date of the provision was exempt when initially made (treating any refinancing as a new loan) and the loan would have been exempt throughout the period of the loan if the provision had been in effect during the period of the loan.

Effective Date

The provision is effective with respect to years beginning after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to loans from pension plans, except that California law does not impose any excise tax on prohibited transactions. California law has not conformed to the changes made to the IRC by the EGTRRA.

Section	Section Title
613	PENSION PLAN - MODIFICATION OF TOP-HEAVY RULES.

Background

In general

Under present law, additional qualification requirements apply to plans that primarily benefit an employer's key employees (“top-heavy plans”). These additional requirements provide (1) more rapid vesting for plan participants who are non-key employees and (2) minimum nonintegrated employer contributions or benefits for plan participants who are non-key employees.

Definition of top-heavy plan

A defined benefit plan is a top-heavy plan if more than 60% of the cumulative accrued benefits under the plan are for key employees. A defined contribution plan is top heavy if the sum of the account balances of key employees is more than 60% of the total account balances under the plan. For each plan year, the determination of top-heavy status generally is made as of the last day of the preceding plan year (“the determination date”).

For purposes of determining whether a plan is a top-heavy plan, benefits derived both from employer and employee contributions, including employee elective contributions, are taken into account. In addition, the accrued benefit of a participant in a defined benefit plan and the account balance of a participant in a defined contribution plan includes any amount distributed within the five-year period ending on the determination date.

An individual's accrued benefit or account balance is not taken into account in determining whether a plan is top-heavy if the individual has not performed services for the employer during the five-year period ending on the determination date.

In some cases, two or more plans of a single employer must be aggregated for purposes of determining whether the group of plans is top-heavy. The following plans must be aggregated: (1) plans which cover a key employee (including collectively bargained plans); and (2) any plan upon which a plan covering a key employee depends for purposes of satisfying the Code's nondiscrimination rules. The employer may be required to include terminated plans in the required aggregation group. In some circumstances, an employer may elect to aggregate plans for purposes of determining whether they are top heavy.

SIMPLE plans are not subject to the top-heavy rules.

Definition of key employee

A key employee is an employee who, during the plan year that ends on the determination date or any of the four preceding plan years, is (1) an officer earning over one-half of the defined benefit plan dollar limitation of section 415 ($70,000 for 2001), (2) a 5% owner of the employer, (3) a 1% owner of the employer earning over $150,000, or (4) one of the 10 employees earning more than the defined contribution plan dollar limit ($35,000 for 2001) with the largest ownership interests in the employer. A family ownership attribution rule applies to the determination of 1% owner status, 5% owner status, and largest ownership interest. Under this attribution rule, an individual is treated as owning stock owned by the individual's spouse, children, grandchildren, or parents.

Minimum benefit for non-key employees

A minimum benefit generally must be provided to all non-key employees in a top-heavy plan. In general, a top-heavy defined benefit plan must provide a minimum benefit equal to the lesser of (1) 2% of compensation multiplied by the employee's years of service, or (2) 20% of compensation. A top-heavy defined contribution plan must provide a minimum annual contribution equal to the lesser of (1) 3% of compensation, or (2) the percentage of compensation at which contributions were made for key employees (including employee elective contributions made by key employees and employer matching contributions).

For purposes of the minimum benefit rules, only benefits derived from employer contributions (other than amounts employees have elected to defer) to the plan are taken into account, and an employee's social security benefits are disregarded (i.e., the minimum benefit is nonintegrated). Employer matching contributions may be used to satisfy the minimum contribution requirement; however, in such a case the contributions are not treated as matching contributions for purposes of applying the special nondiscrimination requirements applicable to employee elective contributions and matching contributions under sections 401(k) and (m). Thus, such contributions would have to meet the general nondiscrimination test of section 401(a)(4).

Top-heavy vesting

Benefits under a top-heavy plan must vest at least as rapidly as under one of the following schedules:
(1) three-year cliff vesting, which provides for 100% vesting after three years of service; and
(2) two-six year graduated vesting, which provides for 20% vesting after two years of service, and 20% more each year thereafter so that a participant is fully vested after six years of service.

Benefits under a plan that is not top heavy must vest at least as rapidly as under one of the following schedules:

(1) five-year cliff vesting; and
(2) three-seven year graded vesting, which provides for 20% vesting after three years and 20% more each year thereafter so that a participant is fully vested after seven years of service.

Qualified cash or deferred arrangements

Under a qualified cash or deferred arrangement (a “section 401(k) plan”), an employee may elect to have the employer make payments as contributions to a qualified plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals. A special nondiscrimination test applies to elective deferrals under cash or deferred arrangements, which compares the elective deferrals of highly compensated employees with elective deferrals of nonhighly compensated employees. (This test is called the actual deferral percentage test or the “ADP” test). Employer matching contributions under qualified defined contribution plans are also subject to a similar nondiscrimination test. (This test is called the actual contribution percentage test or the “ACP” test.)

Under a design-based safe harbor, a cash or deferred arrangement is deemed to satisfy the ADP test if the plan satisfies one of two contribution requirements and satisfies a notice requirement. A plan satisfies the contribution requirement under the safe harbor rule for qualified cash or deferred arrangements if the employer either (1) satisfies a matching contribution requirement or (2) makes a nonelective contribution to a defined contribution plan of at least three percent of an employee's compensation on behalf of each nonhighly compensated employee who is eligible to participate in the arrangement without regard to the permitted disparity rules (sec. 401(1)).

A plan satisfies the matching contribution requirement if, under the arrangement: (1) the employer makes a matching contribution on behalf of each nonhighly compensated employee that is equal to (a) 100% of the employee's elective deferrals up to 3% of compensation and (b) 50% of the employee's elective deferrals from 3% to 5% of compensation; and (2), the rate of match with respect to any elective contribution for highly compensated employees is not greater than the rate of match for nonhighly compensated employees. Matching contributions that satisfy the design-based safe harbor for cash or deferred arrangements are deemed to satisfy the ACP test. Certain additional matching contributions are also deemed to satisfy the ACP test.

New Federal Law (Sec. 416)

Definition of top-heavy plan

EGTRRA provides that a plan consisting of a cash-or-deferred arrangement that satisfies the design-based safe harbor for such plans and matching contributions that satisfy the safe harbor rule for such contributions is not a top-heavy plan. Matching or nonelective contributions provided under such a plan may be taken into account in satisfying the minimum contribution requirements applicable to top-heavy plans. This provision is not intended to preclude the use of nonelective contributions that are used to satisfy the safe harbor rules from being used to satisfy other qualified retirement plan nondiscrimination rules, including those involving cross-testing.

In determining whether a plan is top-heavy, distributions during the year ending on the date the top-heavy determination is being made are taken into account. The present-law five-year rule applies with respect to in-service distributions. Similarly, EGTRRA provides that an individual's accrued benefit or account balance is not taken into account if the individual has not performed services for the employer during the one-year period ending on the date the top-heavy determination is being made.

Definition of key employee

EGTRRA: (1) provides that an employee is not considered a key employee by reason of officer status unless the employee was (a) an officer with compensation in excess of $130,000 (adjusted for inflation in $5,000 increments), (b) a 5% owner, or (c) a 1% owner with compensation in excess of $150,000, and (2) repeals the top-10 owner key employee category. The present-law limits on the number of officers treated as key employees under (1) continue to apply. EGTRRA repeals the four-year lookback rule for determining key employee status and provides that an employee is a key employee only if he or she is a key employee during the preceding plan year.

An employee is considered a key employee if, during the prior year, the employee was (1) an officer with compensation in excess of $130,000 (adjusted for inflation in $5,000 increments), (2) a 5% owner, or (3) a 1% owner with compensation in excess of $150,000. The present-law limits on the number of officers treated as key employees under (1) continue to apply.

Under EGTRRA, the family ownership attribution rule continues to apply in determining whether an individual is a 5% owner of the employer for purposes of the top-heavy rules.

Minimum benefit for non-key employees

Under EGTRRA, matching contributions are taken into account in determining whether the minimum benefit requirement has been satisfied. Thus, this provision overrides the provision in Treasury regulations that, if matching contributions are used to satisfy the minimum benefit requirement, then they are not treated as matching contributions for purposes of the section 401(m) nondiscrimination rules.

EGTRRA provides that, in determining the minimum benefit required under a defined benefit plan, a year of service does not include any year in which no key employee or former key employee benefits under the plan (as determined under sec. 410).

Effective Date

The provision is effective for years beginning after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to top heavy rules for pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

Section	Section Title
614	ELECTIVE DEFERRALS NOT TAKEN INTO ACCOUNT FOR PURPOSES OF DEDUCTION LIMITS.

Background

Employer contributions to one or more qualified retirement plans are deductible subject to certain limits. In general, the deduction limit depends on the kind of plan.

In the case of a defined benefit pension plan or a money purchase pension plan, the employer generally may deduct the amount necessary to satisfy the minimum funding cost of the plan for the year. If a defined benefit pension plan has more than 100 participants, the maximum amount deductible is at least equal to the plan's unfunded current liabilities.

In the case of a profit-sharing or stock bonus plan, the employer generally may deduct an amount equal to 15% of compensation of the employees covered by the plan for the year.

If an employer sponsors both a defined benefit pension plan and a defined contribution plan that covers some of the same employees (or a money purchase pension plan and another kind of defined contribution plan), the total deduction for all plans for a plan year generally is limited to the greater of (1) 25% of compensation or (2) the contribution necessary to meet the minimum funding requirements of the defined benefit pension plan for the year (or the amount of the plan's unfunded current liabilities, in the case of a plan with more than 100 participants).

For purposes of the deduction limits, employee elective deferral contributions to a section 401(k) plan are treated as employer contributions and, thus, are subject to the generally applicable deduction limits.

Subject to certain exceptions, nondeductible contributions are subject to a 10% excise tax.

New Federal Law (Sec. 404)

Under EGTRRA, elective deferral contributions are not subject to the deduction limits, and the application of a deduction limitation to any other employer contribution to a qualified retirement plan does not take into account elective deferral contributions.

Effective Date

The provision is effective for years beginning after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to deferrals for pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

Section	Section Title
615	REPEAL OF COORDINATION REQUIREMENTS FOR DEFERRED COMPENSATION PLANS OF STATE AND LOCAL GOVERNMENTS AND TAX-EXEMPT ORGANIZATIONS.

Background

Compensation deferred under an eligible deferred compensation plan of a tax-exempt or state and local government employer (a “section 457 plan”) is not includible in gross income until paid or made available. In general, the maximum permitted annual deferral under such a plan is the lesser of (1) $8,500 (in 2001) or (2) 33 1/3% of compensation. The $8,500 limit is increased for inflation in $500 increments. Under a special catch-up rule, a section 457 plan may provide that, for one or more of the participant's last three years before retirement, the otherwise applicable limit is increased to the lesser of (1) $15,000 or (2) the sum of the otherwise applicable limit for the year plus the amount by which the limit applicable in preceding years of participation exceeded the deferrals for that year.

The $8,500 limit (as modified under the catch-up rule), applies to all deferrals under all section 457 plans in which the individual participates. In addition, in applying the $8,500 limit, contributions under a tax-sheltered annuity (“section 403(b) annuity”), elective deferrals under a qualified cash or deferred arrangement (“section 401(k) plan”), salary reduction contributions under a simplified employee pension plan (“SEP”), and contributions under a SIMPLE plan are taken into account. Further, the amount deferred under a section 457 plan is taken into account in applying a special catch-up rule for section 403(b) annuities.

New Federal Law (Sec. 457)

EGTRRA repeals the rules coordinating the section 457 dollar limit with contributions under other types of plans. (The limits on deferrals under a section 457 plan are modified under other provisions of EGTRRA.)

Effective Date

The provision is effective for years beginning after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

Section	Section Title
616	PENSION PLAN - DEDUCTION LIMITS.

Background

Employer contributions to one or more qualified retirement plans are deductible subject to certain limits. In general, the deduction limit depends on the kind of plan. Subject to certain exceptions, nondeductible contributions are subject to a 10% excise tax.

In the case of a defined benefit pension plan or a money purchase pension plan, the employer generally may deduct the amount necessary to satisfy the minimum funding cost of the plan for the year. If a defined benefit pension plan has more than 100 participants, the maximum amount deductible is at least equal to the plan's unfunded current liabilities.

In some cases, the amount of deductible contributions is limited by compensation. In the case of a profit-sharing or stock bonus plan, the employer generally may deduct an amount equal to 15% of compensation of the employees covered by the plan for the year.

If an employer sponsors both a defined benefit pension plan and a defined contribution plan that covers some of the same employees (or a money purchase pension plan and another kind of defined contribution plan), the total deduction for all plans for a plan year generally is limited to the greater of (1) 25% of compensation or (2) the contribution necessary to meet the minimum funding requirements of the defined benefit pension plan for the year (or the amount of the plan's unfunded current liabilities, in the case of a plan with more than 100 participants).

In the case of an employee stock ownership plan (“ESOP”), principal payments on a loan used to acquire qualifying employer securities are deductible up to 25% of compensation.

For purposes of the deduction limits, employee elective deferral contributions to a qualified cash or deferred arrangement (“section 401(k) plan”) are treated as employer contributions and, thus, are subject to the generally applicable deduction limits.

For purposes of the deduction limits, compensation means the compensation otherwise paid or accrued during the taxable year to the beneficiaries under the plan, and the beneficiaries under a profit-sharing or stock bonus plan are the employees who benefit under the plan with respect to the employer's contribution. An employee who is eligible to make elective deferrals under a section 401(k) plan is treated as benefiting under the arrangement even if the employee elects not to defer.

For purposes of the deduction rules, compensation generally includes only taxable compensation, and thus does not include salary reduction amounts, such as elective deferrals under a section 401(k) plan or a tax-sheltered annuity ("section 403(b) annuity"), elective contributions under a deferred compensation plan of a tax-exempt organization or a state or local government ("section 457 plan"), and salary reduction contributions under a section 125 cafeteria plan. For purposes of the contribution limits under section 415, compensation does include such salary reduction amounts.

New Federal Law (Sec. 404)

Under EGTRRA, the definition of compensation for purposes of the deduction rules includes salary reduction amounts treated as compensation under section 415. In addition, the annual limitation on the amount of deductible contributions to a profit-sharing or stock bonus plan is increased from 15% to 25% of compensation of the employees covered by the plan for the year. Also, except to the extent provided in regulations, a money purchase pension plan is treated like a profit-sharing or stock bonus plan for purposes of the deduction rules.

Effective Date

The provision is effective for years beginning after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to deduction limits for pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

Section	Section Title
617	OPTION TO TREAT ELECTIVE DEFERRALS AS AFTER-TAX CONTRIBUTIONS

Background

A qualified cash or deferred arrangement ("section 401(k) plan") or a tax-sheltered annuity ("section 403(b) annuity") may permit a participant to elect to have the employer make payments as contributions to the plan or to the participant directly in cash. Contributions made to the plan at the election of a participant are elective deferrals. Elective deferrals must be nonforfeitable and are subject to an annual dollar limitation (sec. 402(g)) and distribution restrictions. In addition, elective deferrals under a section 401(k) plan are subject to special nondiscrimination rules. Elective deferrals (and earnings attributable thereto) are not includible in a participant's gross income until distributed from the plan.

Elective deferrals for a taxable year that exceed the annual dollar limitation ("excess deferrals") are includible in gross income for the taxable year. If an employee makes elective deferrals under a plan (or plans) of a single employer that exceed the annual dollar limitation ("excess deferrals"), then the plan may provide for the distribution of the excess deferrals, with earnings thereon. If the excess deferrals are made to more than one plan of unrelated employers, then the plan may permit the individual to allocate excess deferrals among the various plans, no later than March 1 (April 15 under the applicable regulations) following the end of the taxable year. If excess deferrals are distributed not later than April 15 following the end of the taxable year, along with earnings attributable to the excess deferrals, then the excess deferrals are not again includible in income when distributed.

The earnings are includible in income in the year distributed. If excess deferrals (and income thereon) are not distributed by the applicable April 15, then the excess deferrals (and income thereon) are includible in income when received by the participant. Thus, excess deferrals that are not distributed by the applicable April 15th are taxable both in the taxable year when the deferral was made and in the year the participant receives a distribution of the excess deferral.

Individuals with AGI below certain levels generally may make nondeductible contributions to a Roth IRA and may convert a deductible or nondeductible IRA into a Roth IRA. Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income, nor subject to the additional 10% tax on early withdrawals. A qualified distribution is a distribution that (1) is made after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) is made after attainment of age 59 1/2, is made on account of death or disability, or is a qualified special purpose distribution (i.e., for first-time homebuyer expenses of up to $10,000). A distribution from a Roth IRA that is not a qualified distribution is includible in income to the extent attributable to earnings, and is subject to the 10% tax on early withdrawals (unless an exception applies). Early distributions of converted amounts may also accelerate income inclusion of converted amounts that are taxable under the four-year rule applicable to 1998 conversions.

New Federal Law (Sec. 402A)

A section 401(k) plan or a section 403(b) annuity is permitted to include a “designated Roth contribution“ that permits a participant to elect to have all or a portion of the participant's elective deferrals under the plan treated as designated Roth contributions. Designated Roth contributions are elective deferrals that the participant designates (at such time and in such manner as the Secretary may prescribe) as not excludable from the participant's gross income. It is intended that the Secretary will generally not permit retroactive designations of elective deferrals as designated Roth contributions.

The annual dollar limitation on a participant's designated Roth contributions is the section 402(g) annual limitation on elective deferrals, reduced by the participant's elective deferrals that the participant does not designate as designated Roth contributions. Designated Roth contributions are treated as any other elective deferral for purposes of nonforfeitability requirements and distribution restrictions. Similarly, designated Roth contributions to a section 403(b) annuity are treated the same as other salary reduction contributions to the annuity (except that designated Roth contributions are includible in income).

Under a section 401(k) plan, designated Roth contributions also are treated as any other elective deferral for purposes of the special nondiscrimination requirements. It is intended that the Secretary provide ordering rules regarding the return of excess contributions under the special nondiscrimination rules (pursuant to sec. 401(k)(8)) in the event a participant makes both regular elective deferrals and designated Roth contributions. It is intended that such rules will generally permit a plan to allow participants to designate which contributions are returned first or to permit the plan to specify which contributions are returned first. It is also intended that the Secretary will provide ordering rules to determine the extent to which a distribution consists of excess Roth contributions.

The plan is required to establish a separate account, and maintain separate record keeping, for a participant's designated Roth contributions (and earnings allocable thereto). A qualified distribution from a participant's designated Roth contributions account is not includible in the participant's gross income. A qualified distribution is a distribution that is made after the end of a specified nonexclusion period and that is (1) made on or after the date on which the participant attains age 59 1/2, (2) made to a beneficiary (or to the estate of the participant) on or after the death of the participant, or (3) attributable to the participant's being disabled.

A qualified special purpose distribution, as defined under the rules relating to Roth IRAs, does not qualify as a tax-free distribution from a designated Roth contributions account. The nonexclusion period is the five-year-taxable period beginning with the earlier of (1) the first taxable year for which the participant made a designated Roth contribution to any designated Roth contribution account established for the participant under the plan, or (2) if the participant has made a rollover contribution to the designated Roth contribution account that is the source of the distribution from a designated Roth contribution account established for the participant under another plan, the first taxable year for which the participant made a designated Roth contribution to the previously established account.

A distribution from a designated Roth contributions account that is a corrective distribution of an elective deferral (and income allocable thereto) that exceeds the section 402(g) annual limit on elective deferrals or a corrective distribution of an excess contribution under the special nondiscrimination rules (pursuant to sec. 401(k)(8) (and income allocable thereto) is not a qualified distribution. In addition, the treatment of excess designated Roth contributions is similar to the treatment of excess deferrals attributable to non-designated Roth contributions. If excess designated Roth contributions (including earnings thereon) are distributed no later than the April 15th following the taxable year, then the designated Roth contribution is not includible in gross income as a result of the distribution, because such contributions are includible in gross income when made. Earnings on such excess designated Roth contributions are treated the same as earnings on excess deferrals distributed no later than April 15th, i.e., they are includible in income when distributed. If excess designated Roth contributions are not distributed no later than the applicable April 15th, then such contributions (and earnings thereon) are taxable when distributed. Thus, as is the case with excess elective deferrals that are not distributed by the applicable April 15th, the contributions are includible in income in the year when made and again when distributed from the plan. Earnings on such contributions are taxable when received.

A participant is permitted to roll over a distribution from a designated Roth contributions account only to another designated plus contributions account or a Roth IRA of the participant.

The Secretary of the Treasury is directed to require the plan administrator of each section 401(k) plan or section 403(b) annuity that permits participants to make designated Roth contributions to make such returns and reports regarding designated Roth contributions to the Secretary, plan participants and beneficiaries, and other persons that the Secretary may designate.

Effective Date

The provision is effective for taxable years beginning after December 31, 2005.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

Section	Section Title
631	ENHANCING FAIRNESS FOR WOMEN - ADDITIONAL SALARY REDUCTION CATCH-UP CONTRIBUTIONS.

Background

Elective deferral limitations

Under present law, under certain salary reduction arrangements, an employee may elect to have the employer make payments as contributions to a plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals. The maximum annual amount of elective deferrals that an individual may make to a qualified cash or deferred arrangement (a "401(k) plan"), a tax-sheltered annuity ("section 403(b) annuity") or a salary reduction simplified employee pension plan ("SEP") is $10,500 (for 2001). The maximum annual amount of elective deferrals that an individual may make to a SIMPLE plan is $6,500 (for 2001). These limits are indexed for inflation in $500 increments.

Section 457 plans

The maximum annual deferral under a deferred compensation plan of a state or local government or a tax-exempt organization (a "section 457 plan") is the lesser of (1) $8,500 (for 2001) or (2) 33 1/3% of compensation. The $8,500 dollar limit is increased for inflation in $500 increments. Under a special catch-up rule, the section 457 plan may provide that, for one or more of the participant's last three years before retirement, the otherwise applicable limit is increased to the lesser of (1) $15,000 or (2) the sum of the otherwise applicable limit for the year plus the amount by which the limit applicable in preceding years of participation exceeded the deferrals for that year.

New Federal Law (Sec. 414)

EGTRRA provides that the otherwise applicable dollar limit on elective deferrals under a section 401(k) plan, section 403(b) annuity, SEP, or SIMPLE, or deferrals under a section 457 plan is increased for individuals who have attained age 50 by the end of the year. Another provision of EGTRRA increases the dollar limit on elective deferrals under such arrangements. The catch-up contribution provision does not apply to after-tax employee contributions. Additional contributions may be made by an individual who has attained age 50 before the end of the plan year and with respect to whom no other elective deferrals may otherwise be made to the plan for the year because of the application of any limitation of the Code (e.g., the annual limit on elective deferrals) or of the plan. Under EGTRRA, the additional amount of elective contributions that may be made by an eligible individual participating in such a plan is the lesser of (1) the applicable dollar amount or (2) the participant's compensation for the year reduced by any other elective deferrals of the participant for the year. In the case of a section 457 plan, this catch-up rule does not apply during the participant's last three years before retirement (in those years, the regularly applicable dollar limit is doubled). The applicable dollar amount under a section 401(k) plan, section 403(b) annuity, SEP, or section 457 plan is $1,000 for 2002, $2,000 for 2003, $3,000 for 2004, $4,000 for 2005, and $5,000 for 2006 and thereafter. The applicable dollar amount under a SIMPLE is $500 for 2002, $1,000 for 2003, $1,500 for 2004, $2,000 for 2005, and $2,500 for 2006 and thereafter. The $5,000 and $2,500 amounts are adjusted for inflation in $500 increments in 2007 and thereafter. In the case of a section 457 plan, this catch-up rule does not apply during the participant's last three years before retirement (in those years, the regularly applicable dollar limit is doubled).

Catch-up contributions made under EGTRRA are not subject to any other contribution limits and are not taken into account in applying other contribution limits. In addition, such contributions are not subject to applicable nondiscrimination rules. However, a plan fails to meet the applicable nondiscrimination requirements under section 401(a)(4) with respect to benefits, rights, and features unless the plan allows all eligible individuals participating in the plan to make the same election with respect to catch-up contributions. For purposes of this rule, all plans of related employers are treated as a single plan.

An employer is permitted to make matching contributions with respect to catch-up contributions. Any such matching contributions are subject to the normally applicable rules.

The following examples illustrate the application of EGTRRA, after the catch-up is fully phased-in.

Example 1: Employee A is a highly compensated employee who is over 50 and who participates in a section 401(k) plan sponsored by A's employer. The maximum annual deferral limit (without regard to the provision) is $15,000. After application of the special nondiscrimination rules applicable to section 401(k) plans, the maximum elective deferral A may make for the year is $8,000. Under the provision, A is able to make additional catch-up salary reduction contributions of $5,000.

Example 2: Employee B, who is over 50, is a participant in a section 401(k) plan. B's compensation for the year is $30,000. The maximum annual deferral limit (without regard to the provision) is $15,000. Under the terms of the plan, the maximum permitted deferral is 10% of compensation or, in B's case, $3,000. Under the provision, B can contribute up to $8,000 for the year ($3,000 under the normal operation of the plan, and an additional $5,000 under the provision).

Effective Date

The provision is effective for taxable years beginning after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

Section	Section Title
632	ENHANCING FAIRNESS FOR WOMAN - EQUITABLE TREATMENT FOR CONTRIBUTIONS OF EMPLOYEES TO DEFINED CONTRIBUTION PLANS

Background

Present law imposes limits on the contributions that may be made to tax-favored retirement plans.

Defined contribution plans

In the case of a tax-qualified defined contribution plan, the limit on annual additions that can be made to the plan on behalf of an employee is the lesser of $35,000 (for 2001) or 25% of the employee's compensation (sec. 415(c)). Annual additions include employer contributions, including contributions made at the election of the employee (i.e., employee elective deferrals), after-tax employee contributions, and any forfeitures allocated to the employee. For this purpose, compensation means taxable compensation of the employee, plus elective deferrals, and similar salary reduction contributions. A separate limit applies to benefits under a defined benefit plan.

For years before January 1, 2000, an overall limit applied if an employee was a participant in both a defined contribution plan and a defined benefit plan of the same employer.

Tax-sheltered annuities

In the case of a tax-sheltered annuity (a “section 403(b) annuity”), the annual contribution generally cannot exceed the lesser of the exclusion allowance or the section 415(c) defined contribution limit. The exclusion allowance for a year is equal to 20% of the employee's includible compensation, multiplied by the employee's years of service, minus excludable contributions for prior years under qualified plans, tax-sheltered annuities or section 457 plans of the employer.

In addition to this general rule, employees of nonprofit educational institutions, hospitals, home health service agencies, health and welfare service agencies, and churches may elect application of one of several special rules that increase the amount of the otherwise permitted contributions. The election of a special rule is irrevocable; an employee may not elect to have more than one special rule apply.

Under one special rule, in the year the employee separates from service, the employee may elect to contribute up to the exclusion allowance, without regard to the 25% of compensation limit under section 415. Under this rule, the exclusion allowance is determined by taking into account no more than 10 years of service.

Under a second special rule, the employee may contribute up to the lesser of: (1) the exclusion allowance; (2) 25% of the participant's includible compensation; or (3) $15,000.

Under a third special rule, the employee may elect to contribute up to the section 415(c) limit, without regard to the exclusion allowance. If this option is elected, then contributions to other plans of the employer are also taken into account in applying the limit.

For purposes of determining the contribution limits applicable to section 403(b) annuities, includible compensation means the amount of compensation received from the employer for the most recent period which may be counted as a year of service under the exclusion allowance. In addition, includible compensation includes elective deferrals and similar salary reduction amounts.

Treasury regulations include provisions regarding application of the exclusion allowance in cases where the employee participates in a section 403(b) annuity and a defined benefit plan. The Taxpayer Relief Act of 1997 directed the Secretary of the Treasury to revise these regulations, effective for years beginning after December 31, 1999, to reflect the repeal of the overall limit on contributions and benefits.

Section 457 plans

Compensation deferred under an eligible deferred compensation plan of a tax-exempt or state and local governmental employer (a "section 457 plan") is not includible in gross income until paid or made available. In general, the maximum permitted annual deferral under such a plan is the lesser of (1) $8,500 (in 2001) or (2) 33 1/3% of compensation. The $8,500 limit is increased for inflation in $500 increments.

New Federal Law (Secs. 403(b), 415, & 457)

Increase in defined contribution plan limit

EGTRRA increases the 25% of compensation limitation on annual additions under a defined contribution plan to 100%. Another provision of EGTRRA increases the defined contribution plan dollar limit. EGTRRA preserves the present-law deduction rules for money purchase pension plans. Thus, for purposes of such rules, the limitation on the amount the employer generally may deduct is an amount equal to 25% of compensation of the employees covered by the plan for the year.

It is intended that the Secretary of the Treasury will use the Secretary's existing authority to address situations where qualified nonelective contributions are targeted to certain participants with lower compensation in order to increase the average deferral percentage of nonhighly compensated employees.

For taxable years beginning after December 31, 1999, a plan may disregard the requirement that contributions to a defined benefit plan be treated as previously excluded amounts for purposes of the exclusion allowance.

Conforming limits on tax-sheltered annuities

EGTRRA repeals the exclusion allowance applicable to contributions to tax-sheltered annuities. Thus, such annuities are subject to the limits applicable to tax-qualified plans.

EGTRRA also directs the Secretary of the Treasury to revise the regulations relating to the exclusion allowance under section 403(b)(2) to render void the requirement that contributions to a defined benefit plan be treated as previously excluded amounts for purposes of the exclusion allowance. For taxable years beginning after December 31, 1999, the regulatory provisions regarding the exclusion allowance are to be applied as if the requirement that contributions to a defined benefit plan be treated as previously excluded amounts for purposes of the exclusion allowance were void.

Section 457 plans

EGTRRA increases the 33 1/3% of compensation limitation on deferrals under a section 457 plan to 100% of compensation.

Effective Date

The provision generally is effective for years beginning after December 31, 2001. The provision regarding the regulations under section 403(b)(2) is effective on June 7, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

Section	Section Title
633	ENHANCING FAIRNESS FOR WOMAN - FASTER VESTING OF EMPLOYER MATCHING CONTRIBUTIONS.

Background

Under present law, a plan is not a qualified plan unless a participant's employer-provided benefit vests at least as rapidly as under one of two alternative minimum vesting schedules. A plan satisfies the first schedule if a participant acquires a nonforfeitable right to 100% of the participant's accrued benefit derived from employer contributions upon the completion of five years of service. A plan satisfies the second schedule if a participant has a nonforfeitable right to at least 20% of the participant's accrued benefit derived from employer contributions after three years of service, 40% after four years of service, 60% after five years of service, 80% after six years of service, and 100% after seven years of service. The minimum vesting requirements are also contained in Title I of ERISA.

New Federal Law (Sec. 411)

EGTRRA applies faster vesting schedules to employer matching contributions. Under EGTRRA, employer matching contributions are required to vest at least as rapidly as under one of the following two alternative minimum vesting schedules. A plan satisfies the first schedule if a participant acquires a nonforfeitable right to 100% of employer matching contributions upon the completion of three years of service. A plan satisfies the second schedule if a participant has a nonforfeitable right to 20% of employer matching contributions for each year of service beginning with the participant's second year of service and ending with 100% after six years of service.

Effective Date

The provision is effective for contributions for plan years beginning after December 31, 2001, with a delayed effective date for plans maintained pursuant to a collective bargaining agreement. The provision does not apply to any employee until the employee has an hour of service after the effective date. In applying the new vesting schedule, service before the effective date is taken into account.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

Section	Section Title
634	PENSION PLAN - ENHANCING FAIRNESS FOR WOMAN. MODIFICATIONS TO MINIMUM DISTRIBUTION RULES

Background

In general

Minimum distribution rules apply to all types of tax-favored retirement vehicles, including qualified plans, individual retirement arrangements ("IRAs"), tax-sheltered annuities ("section 403(b) annuities"), and eligible deferred compensation plans of tax-exempt and state and local government employers ("section 457 plans"). In general, under these rules, distribution of minimum benefits must begin no later than the required beginning date. Minimum distribution rules also apply to benefits payable with respect to a plan participant who has died. Failure to comply with the minimum distribution rules results in an excise tax imposed on the individual plan participant equal to 50% of the required minimum distribution not distributed for the year. The excise tax may be waived if the individual establishes to the satisfaction of the Commissioner that the shortfall in the amount distributed was due to reasonable error and reasonable steps are being taken to remedy the shortfall. Under certain circumstances following the death of a participant, the excise tax is automatically waived under proposed Treasury regulations.

Distributions prior to the death of the individual

In the case of distributions prior to the death of the plan participant, the minimum distribution rules are satisfied if either (1) the participant's entire interest in the plan is distributed by the required beginning date, or (2) the participant's interest in the plan is to be distributed (in accordance with regulations), beginning not later than the required beginning date, over a permissible period. The permissible periods are (1) the life of the participant, (2) the lives of the participant and a designated beneficiary, (3) the life expectancy of the participant, or (4) the joint life and last survivor expectancy of the participant and a designated beneficiary. In calculating minimum required distributions, life expectancies of the participant and the participant's spouse may be recomputed annually.

In the case of qualified plans, tax-sheltered annuities, and section 457 plans, the required beginning date is the April 1 of the calendar year following the later of (1) the calendar year in which the employee attains age 70½ or (2) the calendar year in which the employee retires. However, in the case of a 5% owner of the employer, distributions are required to begin no later than the April 1 of the calendar year following the year in which the 5% owner attains age 70½ If commencement of benefits is delayed beyond age 70½ from a defined benefit plan, then the accrued benefit of the employee must be actuarially increased to take into account the period after age 70½ in which the employee was not receiving benefits under the plan. State and local government plans and church plans are not required to actuarially increase benefits that begin after age 70½.

In the case of distributions from an IRA other than a Roth IRA, the required beginning date is the April 1 of the calendar year following the calendar year in which the IRA owner attains age 70½. The pre-death minimum distribution rules do not apply to Roth IRAs.

In general, under the proposed Treasury regulations, in order to satisfy the minimum distribution rules, annuity payments under a defined benefit plan must be paid in periodic payments made at intervals not longer than one year over a permissible period, and must be nonincreasing, or increase only as a result of the following: (1) cost-of-living adjustments; (2) cash refunds of employee contributions; (3) benefit increases under the plan; or (4) an adjustment due to death of the employee's beneficiary. In the case of a defined contribution plan, the minimum required distribution is determined by dividing the employee's benefit by an amount from the uniform table provided in the proposed regulations.

New Federal Law

EGTRRA directs the Treasury to revise the life expectancy tables under the applicable regulations to reflect current life expectancy.

Effective Date

The provision is effective on June 7, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

Section	Section Title
635	PENSION PLAN - ENHANCING FAIRNESS FOR WOMAN - CLARIFICATION OF TAX TREATMENT OF DIVISION OF SECTION 457 PLAN BENEFITS UPON DIVORCE

Background

Under present law, benefits provided under a qualified retirement plan for a participant may not be assigned or alienated to creditors of the participant, except in very limited circumstances. One exception to the prohibition on assignment or alienation rule is a qualified domestic relations order ("QDRO"). A QDRO is a domestic relations order that creates or recognizes a right of an alternate payee to any plan benefit payable with respect to a participant, and that meets certain procedural requirements.

Under present law, a distribution from a governmental plan or a church plan is treated as made pursuant to a QDRO if it is made pursuant to a domestic relations order that creates or recognizes a right of an alternate payee to any plan benefit payable with respect to a participant. Such distributions are not required to meet the procedural requirements that apply with respect to distributions from qualified plans.

Under present law, amounts distributed from a qualified plan generally are taxable to the participant in the year of distribution. However, if amounts are distributed to the spouse (or former spouse) of the participant by reason of a QDRO, the benefits are taxable to the spouse (or former spouse). Amounts distributed pursuant to a QDRO to an alternate payee other than the spouse (or former spouse) are taxable to the plan participant.

Section 457 of the Internal Revenue Code provides rules for deferral of compensation by an individual participating in an eligible deferred compensation plan ("section 457 plan") of a tax-exempt or state and local government employer. The QDRO rules do not apply to section 457 plans.

New Federal Law (Secs. 414(p) & 457)

EGTRRA applies the taxation rules for qualified plan distributions pursuant to a QDRO to distributions made pursuant to a domestic relations order from a section 457 plan. In addition, a section 457 plan does not violate the restrictions on distributions from such plans due to payments to an alternate payee under a QDRO. The special rule applicable to governmental plans and church plans apply for purposes of determining whether a distribution is pursuant to a QDRO.

Effective Date

The provision is effective for transfers, distributions, and payments made after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

Section	Section Title
636	PENSION PLAN - ENHANCING FAIRNESS FOR WOMAN - PROVISIONS RELATING TO HARDSHIP WITHDRAWALS

Background

Elective deferrals under a qualified cash or deferred arrangement (a "section 401(k) plan") may not be distributable prior to the occurrence of one or more specified events. One event upon which distribution is permitted is the financial hardship of the employee. Applicable Treasury regulations provide that a distribution is made on account of hardship only if the distribution is made on account of an immediate and heavy financial need of the employee and is necessary to satisfy the heavy need.

The Treasury regulations provide a safe harbor under which a distribution may be deemed necessary to satisfy an immediate and heavy financial need. One requirement of this safe harbor is that the employee be prohibited from making elective contributions and employee contributions to the plan and all other plans maintained by the employer for at least 12 months after receipt of the hardship distribution.

Under present law, hardship withdrawals of elective deferrals from a qualified cash or deferred arrangement (or 403(b) annuity) are not eligible rollover distributions. Other types of hardship distributions, e.g., employer matching contributions distributed on account of hardship, are eligible rollover distributions. Different withholding rules apply to distributions that are eligible rollover distributions and to distributions that are not eligible rollover distributions. Eligible rollover distributions that are not directly rolled over are subject to withholding at a flat rate of 20%. Distributions that are not eligible rollover distributions are subject to elective withholding. Periodic distributions are subject to withholding as if the distribution were wages; nonperiodic distributions are subject to withholding at a rate of 10%. In either case, the individual may elect not to have withholding apply.

New Federal Law (Secs. 401(k) & 402)

The Secretary of the Treasury is directed to revise the applicable regulations to reduce from 12 months to six months the period during which an employee must be prohibited from making elective contributions and employee contributions in order for a distribution to be deemed necessary to satisfy an immediate and heavy financial need. The revised regulations are to be effective for years beginning after December 31, 2001.

In addition, any distribution made upon hardship of an employee is not an eligible rollover distribution. Thus, such distributions may not be rolled over, and are subject to the withholding rules applicable to distributions that are not eligible rollover distributions. EGTRRA does not modify the rules under which hardship distributions may be made. For example, as under present law, hardship distributions of qualified employer matching contributions are only permitted under the rules applicable to elective deferrals.

EGTRRA is intended to clarify that all assets distributed as a hardship withdrawal, including assets attributable to employee elective deferrals and those attributable to employer matching or nonelective contributions, are ineligible for rollover. This rule is intended to apply to all hardship distributions from any tax qualified plan, including those made pursuant to standards set forth in section 401(k)(2)(B)(i)(IV) (which are applicable to section 401(k) plans and section 403(b) annuities) and to those treated as hardship distributions under any profit-sharing plan (whether or not in accordance with the standards set forth in section 401(k)(2)(B)(i)(IV)). For this purpose, a distribution that could be made either under the hardship provisions of a plan or under other provisions of the plan (such as provisions permitting in-service withdrawal of assets attributable to employer matching or nonelective contributions after a fixed period of years) could be treated as made upon hardship of the employee if the plan treats it that way. For example, if a plan makes an in-service distribution that consists of assets attributable to both elective deferrals (in circumstances where those assets could be distributed only upon hardship) and employer matching or nonelective contributions (which could be distributed in nonhardship circumstances under the plan), the plan is permitted to treat the distribution in its entirety as made upon hardship of the employee.

Effective Date

The provision directing the Secretary to revise the rules relating to safe harbor hardship distributions is effective on June 7, 2001. The provision that hardship distributions are not eligible rollover distributions is effective for distributions made after December 31, 2001. The Secretary has the authority to issue transitional guidance with respect to the provision that hardship distributions are not eligible rollover distributions to provide sufficient time for plans to implement the new rule.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

Section	Section Title
637	ENHANCING FAIRNESS FOR WOMAN - PENSION COVERAGE FOR DOMESTIC AND SIMILAR WORKERS

Background

Under present law, within limits, employers may make deductible contributions to qualified retirement plans for employees. Subject to certain exceptions, a 10% excise tax applies to nondeductible contributions to such plans.

Employers of household workers may establish a pension plan for their employees. Contributions to such plans are not deductible because they are not made in connection with a trade or business of the employer.

New Federal Law (Sec. 4972(c)(6))

The 10% excise tax on nondeductible contributions does not apply to contributions to a SIMPLE plan or a SIMPLE IRA that are nondeductible solely because the contributions are not a trade or business expense under section 162 because they are not made in connection with a trade or business of the employer.

Thus, for example, employers of household workers are able to make contributions to such plans without imposition of the excise tax. As under present law, the contributions are not deductible. The present-law rules applicable to such plans, e.g., contribution limits and nondiscrimination rules, continue to apply. EGTRRA does not apply with respect to contributions on behalf of the individual and members of his or her family.

No inference is intended with respect to the application of the excise tax under present law to contributions that are not deductible because they are not made in connection with a trade or business of the employer.

As under present law, a plan covering domestic workers is not qualified unless the coverage rules are satisfied by aggregating all employees of family members taken into account under the attribution rules in section 414(c), but disregarding employees employed by a controlled group of corporations or a trade or business.

It is intended that EGTRRA is restricted to contributions made by employers of household workers with respect to whom all applicable employment taxes have been and are being paid.

Effective Date

The provision is effective for taxable years beginning after December 31, 2001.

California Law

California law is in conformity, with minor modifications, with federal law as it read on January 1, 1998, as it relates to pension plans. California's early withdrawal on IRA distributions penalty is 2.5%, as opposed to the 10% federal rate. California law has not conformed to the changes made to the IRC by the EGTRRA.

Section	Section Title
641-643	PENSION PLAN - ROLLOVERS OF RETIREMENT PLAN AND IRA DISTRIBUTIONS.

Background

Present law permits the rollover of funds from a tax-favored retirement plan to another tax-favored retirement plan. The rules that apply depend on the type of plan involved. Similarly, the rules regarding the tax treatment of amounts that are not rolled over depend on the type of plan involved.

Distributions from qualified plans

Under present law, an "eligible rollover distribution" from a tax-qualified employer-sponsored retirement plan may be rolled over tax free to a traditional individual retirement arrangement ("IRA") (All references to IRAs refer only to traditional IRAs. A "traditional" IRA refers to IRAs other than Roth IRAs or SIMPLE) or another qualified plan). An eligible rollover distribution may either be rolled over by the distributee within 60 days of the date of the distribution or, as described below, directly rolled over by the distributing plan. An "eligible rollover distribution" means any distribution to an employee of all or any portion of the balance to the credit of the employee in a qualified plan, except the term does not include (1) any distribution which is one of a series of substantially equal periodic payments made (a) for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and the employee's designated beneficiary, or (b) for a specified period of 10 years or more, (2) any distribution to the extent such distribution is required under the minimum distribution rules, and (3) certain hardship distributions. The maximum amount that can be rolled over is the amount of the distribution includible in income, i.e., after-tax employee contributions cannot be rolled over. Qualified plans are not required to accept rollovers.

Distributions from tax-sheltered annuities

Eligible rollover distributions from a tax-sheltered annuity ("section 403(b) annuity") may be rolled over into an IRA or another section 403(b) annuity. Distributions from a section 403(b) annuity cannot be rolled over into a tax-qualified plan. Section 403(b) annuities are not required to accept rollovers.

IRA distributions

Distributions from a traditional IRA, other than minimum required distributions, can be rolled over into another IRA. In general, distributions from an IRA cannot be rolled over into a qualified plan or section 403(b) annuity. An exception to this rule applies in the case of so-called "conduit IRAs." Under the conduit IRA rule, amounts can be rolled from a qualified plan into an IRA and then subsequently rolled back to another qualified plan if the amounts in the IRA are attributable solely to rollovers from a qualified plan. Similarly, an amount may be rolled over from a section 403(b) annuity to an IRA and subsequently rolled back into a section 403(b) annuity if the amounts in the IRA are attributable solely to rollovers from a section 403(b) annuity.

Distributions from section 457 plans

A "section 457 plan" is an eligible deferred compensation plan of a state or local government or tax-exempt employer that meets certain requirements. In some cases, different rules apply under section 457 to governmental plans and plans of tax-exempt employers. For example, governmental section 457 plans are like qualified plans in that plan assets are required to be held in a trust for the exclusive benefit of plan participants and beneficiaries. In contrast, benefits under a section 457 plan of a tax-exempt employer are unfunded, like nonqualified deferred compensation plans of private employers.

Section 457 benefits can be transferred to another section 457 plan. Distributions from a section 457 plan cannot be rolled over to another section 457 plan, a qualified plan, a section 403(b) annuity, or an IRA.

Rollovers by surviving spouses

A surviving spouse that receives an eligible rollover distribution may roll over the distribution into an IRA, but not a qualified plan or section 403(b) annuity.

Direct rollovers and withholding requirements

Qualified plans and section 403(b) annuities are required to provide that a plan participant has the right to elect that an eligible rollover distribution be directly rolled over to another eligible retirement plan. If the plan participant does not elect the direct rollover option, then withholding is required on the distribution at a 20% rate. Distributions from qualified plans and section 403(b) annuities that are not eligible rollover distributions are subject to elective withholding. Periodic distributions are subject to withholding as if the distribution were wages; nonperiodic distributions are subject to withholding at a rate of 10%. In either case, the individual may elect not to have withholding apply.

Notice of eligible rollover distribution

The plan administrator of a qualified plan or a section 403(b) annuity is required to provide a written explanation of rollover rules to individuals who receive a distribution eligible for rollover. In general, the notice is to be provided within a reasonable period of time before making the distribution and is to include an explanation of (1) the provisions under which the individual may have the distribution directly rolled over to another eligible retirement plan, (2) the provision that requires withholding if the distribution is not directly rolled over, (3) the provision under which the distribution may be rolled over within 60 days of receipt, and (4) if applicable, certain other rules that may apply to the distribution. The Treasury Department has provided more specific guidance regarding timing and content of the notice.

Taxation of distributions

As is the case with the rollover rules, different rules regarding taxation of benefits apply to different types of tax-favored arrangements. In general, distributions from a qualified plan, section 403(b) annuity, or IRA are includible in income in the year received. In certain cases, distributions from qualified plans are eligible for capital gains treatment and averaging. These rules do not apply to distributions from another type of plan. Distributions from a qualified plan, IRA, and section 403(b) annuity generally are subject to an additional 10% early withdrawal tax if made before age 591/2. There are a number of exceptions to the early withdrawal tax. Some of the exceptions apply to all three types of plans, and others apply only to certain types of plans. For example, the 10% early withdrawal tax does not apply to IRA distributions for educational expenses, but does apply to similar distributions from qualified plans and section 403(b) annuities. Benefits under a section 457 plan are generally includible in income when paid or made available. The 10% early withdrawal tax does not apply to section 457 plans.

<u>New Federal Law</u> (Sec. 401, 402, 403(b), 408, 457, & 3405)

In general

EGTRRA provides that eligible rollover distributions from qualified retirement plans, section 403(b) annuities, and governmental section 457 plans generally could be rolled over to any of such plans or arrangements. Hardship distributions from governmental section 457 plans would not be considered eligible rollover distributions.

Similarly, distributions from an IRA generally are permitted to be rolled over into a qualified plan, section 403(b) annuity, or governmental section 457 plan. The direct rollover and withholding rules are extended to distributions from a governmental section 457 plan, and such plans are required to provide the written notification regarding eligible rollover distributions. The elective withholding rules applicable to distributions from qualified plans and section 403(b) annuities that are not eligible rollover distributions are also extended to distributions from governmental section 457 plans. Thus, periodic distributions from governmental section 457 plans that are not eligible rollover distributions are subject to withholding as if the distribution were wages and nonperiodic distributions from such plans that are not eligible rollover distributions are subject to withholding at a 10% rate. In either case, the individual may elect not to have withholding apply. The rollover notice (with respect to all plans) is required to include a description of the provisions under which distributions from the plan to which the distribution is rolled over may be subject to restrictions and tax consequences different than those applicable to distributions from the distributing plan. Qualified plans, section 403(b) annuities, and section 457 plans would not be required to accept rollovers.

Some special rules apply in certain cases. A distribution from a qualified plan is not eligible for capital gains or averaging treatment if there was a rollover to the plan that would not have been permitted under present law. Thus, in order to preserve capital gains and averaging treatment for a qualified plan distribution that is rolled over; the rollover would have to be made to a "conduit IRA" as under present law, and then rolled back into a qualified plan. Amounts distributed from a section 457 plan are subject to the early withdrawal tax to the extent the distribution consists of amounts attributable to rollovers from another type of plan. Section 457 plans are required to separately account for such amounts.

Rollover of after-tax contributions

EGTRRA provides that employee after-tax contributions may be rolled over into another qualified plan or a traditional IRA. In the case of a rollover from a qualified plan to another qualified plan, the rollover is permitted to be accomplished only through a direct rollover. In addition, a qualified plan is not permitted to accept rollovers of after-tax contributions unless the plan provides separate accounting for such contributions (and earnings thereon). After-tax contributions (including nondeductible contributions to an IRA) are not permitted to be rolled over from an IRA into a qualified plan, tax-sheltered annuity, or section 457 plan.

In the case of a distribution from a traditional IRA that is rolled over into an eligible rollover plan that is not an IRA, the distribution is attributed first to amounts other than after-tax contributions.

Expansion of spousal rollovers

EGTRRA provides that surviving spouses may roll over distributions to a qualified plan, section 403(b) annuity, or governmental section 457 plan in which the surviving spouse participates.

Treasury regulations

The Secretary is directed to prescribe rules necessary to carry out EGTRRA. Such rules may include, for example, reporting requirements and mechanisms to address mistakes relating to rollovers. It is anticipated that the IRS will develop forms to assist individuals who roll over after-tax contributions to an IRA in keeping track of such contributions. Such forms could, for example, expand Form 8606--Nondeductible IRAs, to include information regarding after-tax contributions.

Effective Date

The provision is effective for distributions made after December 31, 2001. It is intended that the Secretary will revise the safe harbor rollover notice that plans may use to satisfy the rollover requirements. No penalty is imposed on a plan for a failure to provide the information required under EGTRRA with respect to any distribution made before the date that is 90 days after the date the Secretary issues a new safe harbor rollover notice, if the plan administrator makes a reasonable attempt to comply with such notice requirement. For example, EGTRRA requires that the rollover notice include a description of the provisions under which distributions from the eligible retirement plan receiving the distribution may be subject to restrictions and tax consequences which are different from those applicable to distributions from the plan making the distribution. A plan is treated as making a reasonable good faith effort to comply with this requirement if the notice states that distributions from the plan to which the rollover is made may be subject to different restrictions and tax consequences than those that apply to distributions from the plan from which the rollover is made.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to rollovers of pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

Section Section Title
644 PENSION PLAN - WAIVER OF 60-DAY RULE.

Background
Under present law, amounts received from an IRA or qualified plan may be rolled over tax free if the rollover is made within 60 days of the date of the distribution. The Secretary does not have the authority to waive the 60-day requirement, except during military service in a combat zone or by reason of a Presidentially declared disaster. The Secretary has issued regulations postponing the 60-day rule in such cases.

New Federal Law (Secs. 402 & 408)

EGTRRA provides that the Secretary may waive the 60-day rollover period if the failure to waive such requirement would be against equity or good conscience, including cases of casualty, disaster, or other events beyond the reasonable control of the individual subject to such requirement. For example, the Secretary may issue guidance that includes objective standards for a waiver of the 60-day rollover period, such as waiving the rule due to military service in a combat zone or during a Presidentially declared disaster (both of which are provided for under present law), or for a period during which the participant has received payment in the form of a check, but has not cashed the check, or for errors committed by a financial institution, or in cases of inability to complete a rollover due to death, disability, hospitalization, incarceration, restrictions imposed by a foreign country, or postal error.

Effective Date

The provision applies to distributions made after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to the 60-day rule for pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

Section Section Title
645 PENSION PLAN - TREATMENT OF FORMS OF DISTRIBUTION.

Background

An amendment of a qualified retirement plan may not decrease the accrued benefit of a plan participant. An amendment is treated as reducing an accrued benefit if, with respect to benefits accrued before the amendment is adopted, the amendment has the effect of either (1) eliminating or reducing an early retirement benefit or a retirement-type subsidy, or (2) except as provided by Treasury regulations, eliminating an optional form of benefit (sec. 411(d)(6)). A similar provision is contained in Title I of ERISA.

Under regulations recently issued by the Secretary, this prohibition against the elimination of an optional form of benefit does not apply in the case of (1) a defined contribution plan that offers a lump sum at the same time as the form being eliminated if the participant receives at least 90 days' advance notice of the elimination, or (2) a voluntary transfer between defined contribution plans, subject to the requirements that a transfer from a money purchase pension plan, an ESOP, or a section 401(k) plan must be to a plan of the same type and that the transfer be made in connection with certain corporate mergers, acquisitions, or similar transactions or changes in employment status

New Federal Law (Sec. 411(d)(6))

A defined contribution plan to which benefits are transferred will not be treated as reducing a participant's or beneficiary's accrued benefit even though it does not provide all of the forms of distribution previously available under the transferor plan if (1) the plan receives from another defined contribution plan a direct transfer of the participant's or beneficiary's benefit accrued under the transferor plan, or the plan results from a merger or other transaction that has the effect of a direct transfer (including consolidations of benefits attributable to different employers within a multiple employer plan), (2) the terms of both the transferor plan and the transferee plan authorize the transfer, (3) the transfer occurs pursuant to a voluntary election by the participant or beneficiary that is made after the participant or beneficiary received a notice describing the consequences of making the election, and (4) the transferee plan allows the participant or beneficiary to receive distribution of his or her benefit under the transferee plan in the form of a single sum distribution. EGTRRA does not modify the rules relating to survivor annuities under section 417. Thus, as under present law, a plan that is a transferee of a plan subject to the joint and survivor rules is also subject to those rules.

Except to the extent provided by the Secretary of the Treasury in regulations, a defined contribution plan is not treated as reducing a participant's accrued benefit if (1) a plan amendment eliminates a form of distribution previously available under the plan, (2) a single sum distribution is available to the participant at the same time or times as the form of distribution eliminated by the amendment, and (3) the single sum distribution is based on the same or greater portion of the participant's accrued benefit as the form of distribution eliminated by the amendment.

Furthermore, EGTRRA directs the Secretary of the Treasury to provide by regulations that the prohibitions against eliminating or reducing an early retirement benefit, a retirement-type subsidy, or an optional form of benefit do not apply to plan amendments that eliminate or reduce early retirement benefits, retirement-type subsidies, and optional forms of benefit that create significant burdens and complexities for a plan and its participants, but only if such an amendment does not adversely affect the rights of any participant in more than a de minimis manner.

It is intended that the factors to be considered in determining whether an amendment has more than a de minimis adverse effect on any participant will include (1) all of the participant's early retirement benefits, retirement-type subsidies, and optional forms of benefits that are reduced or eliminated by the amendment, (2) the extent to which early retirement benefits, retirement-type subsidies, and optional forms of benefit in effect with respect to a participant after the amendment effective date provide rights that are comparable to the rights that are reduced or eliminated by the plan amendment, (3) the number of years before the participant attains normal retirement age under the plan (or early retirement age, as applicable), (4) the size of the participant's benefit that is affected by the plan amendment, in relation to the amount of the participant's compensation, and (5) the number of years before the plan amendment is effective.

This provision does not affect the rules relating to involuntary cash outs (sec. 411(a)(11)) or survivor annuity requirements (sec. 417). Accordingly, if a participant is entitled to protections of the joint and survivor rules, those protections may not be eliminated. The intent of the provision authorizing regulations is solely to permit the elimination of early retirement benefits, retirement-type subsidies, or optional forms of benefit that have no more than a de minimis effect on any participant but create disproportionate burdens and complexities for a plan and its participants.

For example, assume the following. Employer A acquires employer B and merges B's defined benefit plan into A's defined benefit plan. The defined benefit plan maintained by B before the merger provides an early retirement subsidy for individuals age 55 with a specified number of years of service. E1 and E2 are employees of B and who transfer to A in connection with the merger. E1 is 25 years old and has compensation of $40,000. The present value of E1's early retirement subsidy under B's plan is $75. E2 is 50 years old and also has compensation of $40,000. The present value of E2's early retirement subsidy under B's plan is $10,000.

Assume that A's plan has an early retirement subsidy for individuals who have attained age 50 with a specified number of years of service, but the subsidy is not the same as under B's plan. Under A's plan, the present value of E2's early retirement subsidy is $9,850. Maintenance of both subsidies after the plan merger would create burdens for the plan and complexities for the plan and its participants.

Treasury regulations could permit E1's early retirement subsidy under B's plan to be eliminated entirely (i.e., even if A's plan did not have an early retirement subsidy). Taking into account all relevant factors, including the value of the benefit, E1's compensation, and the number of years until E1 would be eligible to receive the subsidy, the subsidy is de minimis. Treasury regulations could permit E2's early retirement subsidy under B's plan to be eliminated as to be replaced by the subsidy under A's plan, because the difference in the subsidies is de minimis. However, A's subsidy could not be entirely eliminated. The Secretary is directed to issue, not later than December 31, 2003, final regulations under section 411(d)(6), including regulations required under EGTRRA.

Effective Date

The provision is effective for years beginning after December 31, 2001, except that the direction to the Secretary is effective on June 7, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

Section	Section Title
646	PENSION PLAN - RATIONALIZATION OF RESTRICTIONS ON DISTRIBUTIONS

Background

Elective deferrals under a qualified cash or deferred arrangement (“section 401(k) plan”), tax-sheltered annuity (“section 403(b) annuity”), or an eligible deferred compensation plan of a tax-exempt organization or state or local government (“section 457 plan”), may not be distributable prior to the occurrence of one or more specified events. These permissible distributable events include “separation from service.”

A separation from service occurs only upon a participant's death, retirement, resignation or discharge, and not when the employee continues on the same job for a different employer as a result of the liquidation, merger, consolidation or other similar corporate transaction. A severance from employment occurs when a participant ceases to be employed by the employer that maintains the plan. Under a so-called “same desk rule,” a participant's severance from employment does not necessarily result in a separation from service.

In addition to separation from service and other events, a section 401(k) plan that is maintained by a corporation may permit distributions to certain employees who experience a severance from employment with the corporation that maintains the plan but do not experience a separation from service because the employees continue on the same job for a different employer as a result of a corporate transaction. If the corporation disposes of substantially all of the assets used by the corporation in a trade or business, a distributable event occurs with respect to the accounts of the employees who continue employment with the corporation that acquires the assets. If the corporation disposes of its interest in a subsidiary, a distributable event occurs with respect to the accounts of the employees who continue employment with the subsidiary. Under a recent IRS ruling, a person is generally deemed to have separated from service if that person is transferred to another employer in connection with a sale of less than substantially all the assets of a trade or business.

New Federal Law (Secs. 401(k), 403(b), & 457)

EGTRRA modifies the distribution restrictions applicable to section 401(k) plans, section 403(b) annuities, and section 457 plans to provide that distribution may occur upon severance from employment rather than separation from service. In addition, the provisions for distribution from a section 401(k) plan based upon a corporation's disposition of its assets or a subsidiary are repealed; this special rule is no longer necessary under EGTRRA.

It is intended that a plan may provide that certain specified types of severance from employment do not constitute distributable events. For example, a plan could provide that a severance from employment is not a distributable event if it would not have constituted a “separation from service” under the law in effect prior to a specified date. Also, if a plan describes distributable events by reference to section 401(k)(2), the plan may be amended to restrict distributable events to fewer than all events that constitute a severance from employment. Thus, for example, if a plan sponsor had employees who experienced a severance from employment in the past that the “same desk rule” prevented from being treated as a distributable event, the plan sponsor would have the option of providing in the plan that such severance from employment would, or would not, be treated as a distributable event under the plan.

It is also intended that, as under current law, if there is a transfer of plan assets and liabilities relating to any portion of an employee's benefit under a plan of the employee's former employer to a plan being maintained or created by the employee's new employer (other than a rollover or elective transfer), then that employee has not experienced a severance from employment with the employer maintaining the plan that covers the employee.

Effective Date

The provision is effective for distributions after December 31, 2001, regardless of when the severance of employment occurred.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

Section	Section Title
647	PURCHASE OF SERVICE CREDIT UNDER GOVERNMENTAL PENSION PLANS.

Background

A qualified retirement plan maintained by a state or local government employer may provide that a participant may make after-tax employee contributions in order to purchase permissive service credit, subject to certain limits (sec. 415). Permissive service credit means credit for a period of service recognized by the governmental plan only if the employee voluntarily contributes to the plan an amount (as determined by the plan) that does not exceed the amount necessary to fund the benefit attributable to the period of service and that is in addition to the regular employee contributions, if any, under the plan.

In the case of any repayment of contributions and earnings to a governmental plan with respect to an amount previously refunded upon a forfeiture of service credit under the plan (or another plan maintained by a state or local government employer within the same state), any such repayment is not taken into account for purposes of the section 415 limits on contributions and benefits. Also, service credit obtained as a result of such a repayment is not considered permissive service credit for purposes of the section 415 limits. A participant may not use a rollover or direct transfer of benefits from a tax-sheltered annuity ("section 403(b) annuity") or an eligible deferred compensation plan of a tax-exempt organization or a state or local government ("section 457 plan") to purchase permissive service credits or repay contributions and earnings with respect to a forfeiture of service credit.

New Federal Law (Secs. 403(b) & 457)

A participant in a state or local governmental plan is not required to include in gross income a direct trustee-to-trustee transfer to a governmental defined benefit plan from a section 403(b) annuity or a section 457 plan if the transferred amount is used (1) to purchase permissive service credits under the plan, or (2) to repay contributions and earnings with respect to an amount previously refunded under a forfeiture of service credit under the plan (or another plan maintained by a state or local government employer within the same state).

Effective Date

The provision is effective for transfers after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

Section	Section Title
648	PENSION PLAN - EMPLOYERS MAY DISREGARD ROLLOVERS FOR PURPOSES OF CASH-OUT RULES

Background

If a qualified retirement plan participant ceases to be employed by the employer that maintains the plan, the plan may distribute the participant's nonforfeitable accrued benefit without the consent of the participant and, if applicable, the participant's spouse, if the present value of the benefit does not exceed $5,000. If such an involuntary distribution occurs and the participant subsequently returns to employment covered by the plan, then service taken into account in computing benefits payable under the plan after the return need not include service with respect to which a benefit was involuntarily distributed unless the employee repays the benefit.

Generally, a participant may roll over an involuntary distribution from a qualified plan to an IRA or to another qualified plan. Other Act provisions expand the kinds of plans to which benefits may be rolled over.

New Federal Law (Sec. 411(a)(11))

For purposes of the cash-out rule, a plan is permitted to provide that the present value of a participant's nonforfeitable accrued benefit is determined without regard to the portion of such benefit that is attributable to rollover contributions (and any earnings allocable thereto).

Effective Date

The provision is effective for distributions after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

Section Section Title
649 MINIMUM DISTRIBUTION AND INCLUSION REQUIREMENTS FOR SECTION 457 PLANS.

Background

A “section 457 plan” is an eligible deferred compensation plan of a state or local government or tax-exempt employer that meets certain requirements. For example, amounts deferred under a section 457 plan cannot exceed certain limits. Amounts deferred under a section 457 plan are generally includible in income when paid or made available. Amounts deferred under a plan of deferred compensation of a state or local government or tax-exempt employer that does not meet the requirements of section 457 are includible in income when the amounts are not subject to a substantial risk of forfeiture, regardless of whether the amounts have been paid or made available. This rule of inclusion does not apply to amounts deferred under a tax-qualified retirement plan or similar plans.

Section 457 plans are subject to the minimum distribution rules applicable to tax-qualified pension plans. In addition, such plans are subject to additional minimum distribution rules (sec. 457(d)(2)(B)).

New Federal Law (Sec. 457)

EGTRRA provides that amounts deferred under a section 457 plan of a state or local government are includible in income when paid. EGTRRA also repeals the special minimum distribution rules applicable to section 457 plans. Thus, such plans are subject to the minimum distribution rules applicable to qualified plans.

Effective Date

The provision is effective for distributions after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

Section	Section Title
651-652	PHASE IN REPEAL OF 160% OF CURRENT LIABILITY FUNDING LIMIT; DEDUCTION FOR CONTRIBUTIONS TO FUND TERMINATION LIABILITY

Background

Under present law, defined benefit pension plans are subject to minimum funding requirements designed to ensure that pension plans have sufficient assets to pay benefits. A defined benefit pension plan is funded using one of a number of acceptable actuarial cost methods.

No contribution is required under the minimum funding rules in excess of the full funding limit. The full funding limit is generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 160% of the plan's current liability, over (2) the value of the plan's assets (sec. 412(c)(7)). In general, current liability is all liabilities to plan participants and beneficiaries accrued to date, whereas the accrued liability full funding limit is based on projected benefits. The current liability full funding limit is scheduled to increase as follows: 165% for plan years beginning in 2003 and 2004, and 170% for plan years beginning in 2005 and thereafter. In no event is a plan's full funding limit less than 90% of the plan's current liability over the value of the plan's assets.

An employer sponsoring a defined benefit pension plan generally may deduct amounts contributed to satisfy the minimum funding standard for the plan year. Contributions in excess of the full funding limit generally are not deductible. Under a special rule, an employer that sponsors a defined benefit pension plan (other than a multiemployer plan) which has more than 100 participants for the plan year may deduct amounts contributed of up to 100% of the plan's unfunded current liability.

New Federal Law (Secs. 404(a)(1), 412(c)(7), & 4972(c))

Current liability full funding limit

EGTRRA gradually increases and then repeals the current liability full funding limit. Under EGTRRA, the current liability full funding limit is 165% of current liability for plan years beginning in 2002, and 170% for plan years beginning in 2003. The current liability full funding limit is repealed for plan years beginning in 2004 and thereafter. Thus, in 2004 and thereafter, the full funding limit is the excess, if any, of (1) the accrued liability under the plan (including normal cost), over (2) the value of the plan's assets.

Deduction for contributions to fund termination liability

The special rule allowing a deduction for unfunded current liability generally is extended to all defined benefit pension plans, i.e., EGTRRA applies to multiemployer plans and plans with 100 or fewer participants. The special rule does not apply to plans not covered by the PBGC termination insurance program. The PBGC termination insurance program does not cover plans of professional service employers that have fewer than 25 participants. EGTRRA also modifies the rule by providing that the deduction is for up to 100% of unfunded termination liability, determined as if the plan terminated at the end of the plan year. In the case of a plan with less than 100 participants for the plan year, termination liability does not include the liability attributable to benefit increases for highly compensated employees resulting from a plan amendment which was made or became effective, whichever is later, within the last two years. This rule to provide that the deduction is for up to 100% of unfunded termination liability is applicable only for a plan that terminates within the plan year.

Effective Date

The provision is effective for plan years beginning after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

Section	Section Title
654	PENSION PLAN - MODIFICATIONS TO SECTION 415 LIMITS FOR MULTIEMPLOYER PLANS.

Background

Under present law, limits apply to contributions and benefits under qualified plans (sec. 415). The limits on contributions and benefits under qualified plans are based on the type of plan. Under a defined benefit plan, the maximum annual benefit payable at retirement is generally the lesser of (1) 100% of average compensation for the highest three years, or (2) $140,000 (for 2001). The dollar limit is adjusted for cost-of-living increases in $5,000 increments. The dollar limit is reduced in the case of retirement before the social security retirement age and increases in the case of retirement after the social security retirement age

A special rule applies to governmental defined benefit plans. In the case of such plans, the defined benefit dollar limit is reduced in the case of retirement before age 62 and increased in the case of retirement after age 65. In addition, there is a floor on early retirement benefits. Pursuant to this floor, the minimum benefit payable at age 55 is $75,000.

In the case of a defined contribution plan, the limit on annual additions is the lesser of (1) 25% of compensation or (2) $35,000 (for 2001). Another provision of EGTRRA increases this limit to 100% of compensation.

In applying the limits on contributions and benefits, plans of the same employer are aggregated. That is, all defined benefit plans of the same employer are treated as a single plan, and all defined contribution plans of the same employer are treated as a single plan. Under Treasury regulations, multiemployer plans are not aggregated with other multiemployer plans. However, if an employer maintains both a plan that is not a multiemployer plan and a multiemployer plan, the plan that is not a multiemployer plan is aggregated with the multiemployer plan to the extent that benefits provided under the multiemployer plan are provided with respect to a common participant.

New Federal Law (Sec. 415)

Under EGTRRA, the 100% of compensation defined benefit plan limit does not apply to multiemployer plans. With respect to aggregation of multiemployer plans with other plans, EGTRRA provides that multiemployer plans are not aggregated with single-employer defined benefit plans maintained by an employer contributing to the multiemployer plan for purposes of applying the 100% of compensation limit to such single-employer plan.

Effective Date

The provision is effective for years beginning after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

Section Section Title
655 PENSION PLAN - INVESTMENT OF EMPLOYEE CONTRIBUTIONS IN 401(K) PLANS

Background

The Employee Retirement Income Security Act of 1974, as amended ("ERISA") prohibits certain employee benefit plans from acquiring securities or real property of the employer who sponsors the plan if, after the acquisition, the fair market value of such securities and property exceeds 10% of the fair market value of plan assets. The 10% limitation does not apply to any "eligible individual account plans" that specifically authorize such investments. Generally, eligible individual account plans are defined contribution plans, including plans containing a cash or deferred arrangement ("401(k) plans").

The term "eligible individual account plan" does not include the portion of a plan that consists of elective deferrals (and earnings on the elective deferrals) made under section 401(k) if elective deferrals equal to more than 1% of any employee's eligible compensation are required to be invested in employer securities and employer real property. Eligible compensation is compensation that is eligible to be deferred under the plan. The portion of the plan that consists of elective deferrals (and earnings thereon) is still treated as an individual account plan, and the 10% limitation does not apply, as long as elective deferrals (and earnings thereon) are not required to be invested in employer securities or employer real property. The rule excluding elective deferrals (and earnings thereon) from the definition of individual account plan does not apply if individual account plans are a small part of the employer's retirement plans. In particular, that rule does not apply to an individual account plan for a plan year if the value of the assets of all individual account plans maintained by the employer do not exceed 10% of the value of the assets of all pension plans maintained by the employer (determined as of the last day of the preceding plan year). Multiemployer plans are not taken into account in determining whether the value of the assets of all individual account plans maintained by the employer exceed 10% of the value of the assets of all pension plans maintained by the employer.

The rule excluding elective deferrals (and earnings thereon) from the definition of individual account plan does not apply to an employee stock ownership plan as defined in section 4975(e)(7) of the Internal Revenue Code.

The rule excluding elective deferrals (and earnings thereon) from the definition of individual account plan applies to elective deferrals for plan years beginning after December 31, 1998 (and earnings thereon). It does not apply with respect to earnings on elective deferrals for plan years beginning before January 1, 1999.

New Federal Law (Sec. 1524(b) of the Taxpayer Relief Act of 1997)

EGTRRA modifies the effective date of the rule excluding certain elective deferrals (and earnings thereon) from the definition of individual account plan by providing that the rule does not apply to any elective deferral used to acquire an interest in the income or gain from employer securities or employer real property acquired (1) before January 1, 1999, or (2) after such date pursuant to a written contract which was binding on such date and at all times thereafter.

Effective Date

The provision is effective as if included in the section of the Taxpayer Relief Act of 1997 that contained the rule excluding certain elective deferrals (and earnings thereon).

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

Section	Section Title
656	PROHIBITED ALLOCATIONS OF STOCK IN AN S CORPORATION ESOP.

Background

The Small Business Job Protection Act of 1996 allowed qualified retirement plan trusts described in section 401(a) to own stock in an S corporation. That Act treated the plan's share of the S corporation's income (and gain on the disposition of the stock) as includible in full in the trust's unrelated business taxable income ("UBTI").

The Tax Relief Act of 1997 repealed the provision treating items of income or loss of an S corporation as UBTI in the case of an employee stock ownership plan ("ESOP"). Thus, the income of an S corporation allocable to an ESOP is not subject to current taxation.

Present law provides a deferral of income on the sales of certain employer securities to an ESOP (sec. 1042). A 50% excise tax is imposed on certain prohibited allocations of securities acquired by an ESOP in a transaction to which section 1042 applies. In addition, such allocations are currently includible in the gross income of the individual receiving the prohibited allocation.

New Federal Law (Secs. 409 & 4979a)

In general

Under EGTRRA, if there is a nonallocation year with respect to an ESOP maintained by an S corporation: (1) the amount allocated in a prohibited allocation to an individual who is a disqualified person is treated as distributed to such individual (i.e., the value of the prohibited allocation is includible in the gross income of the individual receiving the prohibited allocation); (2) an excise tax is imposed on the S corporation equal to 50% of the amount involved in a prohibited allocation; and (3) an excise tax is imposed on the S corporation with respect to any synthetic equity owned by a disqualified person. The plan is not disqualified merely because an excise tax is imposed under the provision.

It is intended that EGTRRA will limit the establishment of ESOPs by S corporations to those that provide broad-based employee coverage and that benefit rank-and-file employees as well as highly compensated employees and historical owners.

Definition of nonallocation year

A nonallocation year means any plan year of an ESOP holding shares in an S corporation if, at any time during the plan year, disqualified persons own at least 50% of the number of outstanding shares of the S corporation.

A person is a disqualified person if the person is either (1) a member of a "deemed 20% shareholder group" or (2) a "deemed 10% shareholder." A person is a member of a "deemed 20% shareholder group" if the aggregate number of deemed-owned shares of the person and his or her family members is at least 20% of the number of deemed-owned shares of stock in the S corporation. A person is a deemed 10% shareholder if the person is not a member of a deemed 20% shareholder group and the number of the person's deemed-owned shares is at least 10% of the number of deemed-owned shares of stock of the corporation. A family member of a member of a "deemed 20% shareholder group" with deemed owned shares is also treated as a disqualified person.

In general, “deemed-owned shares” means: (1) stock allocated to the account of an individual under the ESOP, and (2) an individual's share of unallocated stock held by the ESOP. An individual's share of unallocated stock held by an ESOP is determined in the same manner as the most recent allocation of stock under the terms of the plan. For purposes of determining whether there is a nonallocation year, ownership of stock generally is attributed under the rules of section 318. These attribution rules also apply to stock treated as owned by reason of the ownership of synthetic equity, except that: (1) the family attribution rules are modified to include certain other family members, as described below, (2) option attribution does not apply (but instead special rules relating to synthetic equity described below apply), and (3) “deemed-owned shares” held by the ESOP are treated as held by the individual with respect to whom they are deemed owned.

Under the provision, family members of an individual include (1) the spouse of the individual, (2) an ancestor or lineal descendant of the individual or his or her spouse, (3) a sibling of the individual (or the individual's spouse) and any lineal descendant of the brother or sister, and (4) the spouse of any person described in (2) or (3).

EGTRRA contains special rules applicable to synthetic equity interests. Except to the extent provided in regulations, the stock on which a synthetic equity interest is based are treated as outstanding stock of the S corporation and as deemed-owned shares of the person holding the synthetic equity interest if such treatment will result in the treatment of any person as a disqualified person or the treatment of any year as a nonallocation year. Thus, for example, disqualified persons for a year include those individuals who are disqualified persons under the general rule (i.e., treating only those shares held by the ESOP as deemed-owned shares) and those individuals who are disqualified individuals if synthetic equity interests are treated as deemed-owned shares.

“Synthetic equity” means any stock option, warrant, restricted stock, deferred issuance stock right, or similar interest that gives the holder the right to acquire or receive stock of the S corporation in the future. Except to the extent provided in regulations, synthetic equity also includes a stock appreciation right, phantom stock unit, or similar right to a future cash payment based on the value of such stock or appreciation in such value. The provisions relating to synthetic equity do not modify the rules relating to S corporations, e.g., the circumstances in which options or similar interests are treated as creating a second class of stock.

Ownership of synthetic equity is attributed in the same manner as stock is attributed under EGTRRA (as described above). In addition, ownership of synthetic equity is attributed under the rules of section 318(a)(2) and (3) in the same manner as stock.

Definition of prohibited allocation

An ESOP of an S corporation is required to provide that no portion of the assets of the plan attributable to (or allocable in lieu of) S corporation stock may, during a nonallocation year, accrue (or be allocated directly or indirectly under any qualified plan of the S corporation) for the benefit of a disqualified person. A “prohibited allocation” refers to violations of this provision. A prohibited allocation occurs, for example, if income on S corporation stock held by an ESOP is allocated to the account of an individual who is a disqualified person.

Application of excise tax

In the case of a prohibited allocation, the S corporation is liable for an excise tax equal to 50% of the amount of the allocation. For example, if S corporation stock is allocated in a prohibited allocation, the excise tax is equal to 50% of the fair market value of such stock.

A special rule applies in the case of the first nonallocation year, regardless of whether there is a prohibited allocation. In that year, the excise tax also applies to the fair market value of the deemed-owned shares of any disqualified person held by the ESOP, even though those shares are not allocated to the disqualified person in that year. As mentioned above, the S corporation also is liable for an excise tax with respect to any synthetic equity interest owned by any disqualified person in a nonallocation year. The excise tax is 50% of the value of the shares on which synthetic equity is based.

Treasury regulations

The Treasury Department is given the authority to prescribe such regulations as may be necessary to carry out the purposes of EGTRRA.

EGTRRA authorizes the Secretary to determine, by regulation or other guidance of general applicability, that a nonallocation year occurs in any case in which the principal purpose of the ownership structure of an S corporation constitutes, in substance, an avoidance or evasion of the prohibited allocation rules. For example, this might apply if more than 10 independent businesses are combined in an S corporation owned by an ESOP in order to take advantage of the income tax treatment of S corporations owned by an ESOP.

Effective Date

The provision generally is effective with respect to plan years beginning after December 31, 2004. In the case of an ESOP established after March 14, 2001, or an ESOP established on or before such date if the employer maintaining the plan was not an S corporation on such date, the provision is effective with respect to plan years ending after March 14, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

Section Section Title
657 PENSION PLAN - AUTOMATIC ROLLOVERS OF CERTAIN MANDATORY DISTRIBUTIONS.

Background

If a qualified retirement plan participant ceases to be employed by the employer that maintains the plan, the plan may distribute the participant's nonforfeitable accrued benefit without the consent of the participant and, if applicable, the participant's spouse, if the present value of the benefit does not exceed $5,000. If such an involuntary distribution occurs and the participant subsequently returns to employment covered by the plan, then service taken into account in computing benefits payable under the plan after the return need not include service with respect to which a benefit was involuntarily distributed unless the employee repays the benefit.

Generally, a participant may roll over an involuntary distribution from a qualified plan to an IRA or to another qualified plan. Before making a distribution that is eligible for rollover, a plan administrator must provide the participant with a written explanation of the ability to have the distribution rolled over directly to an IRA or another qualified plan and the related tax consequences.

New Federal Law (Sec. 404(c) of ERISA)

EGTRRA makes a direct rollover the default option for involuntary distributions that exceed $1,000 and that are eligible rollover distributions from qualified retirement plans. The distribution must be rolled over automatically to a designated IRA, unless the participant affirmatively elects to have the distribution transferred to a different IRA or a qualified plan or to receive it directly.

The written explanation provided by the plan administrator is required to explain that an automatic direct rollover will be made unless the participant elects otherwise. The plan administrator is also required to notify the participant in writing (as part of the general written explanation or separately) that the distribution may be transferred without cost to another IRA.

EGTRRA amends the fiduciary rules of ERISA so that, in the case of an automatic direct rollover, the participant is treated as exercising control over the assets in the IRA upon the earlier of (1) the rollover of any portion of the assets to another IRA, or (2) one year after the automatic rollover.

EGTRRA directs the Secretary of Labor to issue safe harbors under which the designation of an institution and investment of funds in accordance with EGTRRA are deemed to satisfy the requirements of section 404(a) of ERISA. In addition, EGTRRA authorizes and directs the Secretary of the Treasury and the Secretary of Labor to give consideration to providing special relief with respect to the use of low-cost individual retirement plans for purposes of the provision and for other uses that promote the preservation of tax-qualified retirement assets for retirement income purposes. EGTRRA directs the Secretary of Labor to adopt final regulations implementing EGTRRA not later than three years after June 7, 2001

Effective Date

The provision applies to distributions that occur after the Department of Labor has adopted final regulations implementing EGTRRA.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

Section	Section Title
658	CLARIFICATION OF TREATMENT OF CONTRIBUTIONS TO A MULTIEMPLOYER PLAN.

Background

Employer contributions to one or more qualified retirement plans are deductible subject to certain limits. In general, contributions are deductible for the taxable year of the employer in which the contributions are made. Under a special rule, an employer may be deemed to have made a contribution on the last day of the preceding taxable year if the contribution is on account of the preceding taxable year and is made not later than the time prescribed by law for filing the employer's income tax return for that taxable year (including extensions).

A change in method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. A material item is any item that involves the proper time for the inclusion of the item in income or taking of a deduction.

A change in method of accounting does not include correction of mathematical or posting errors, or errors in the computation of tax liability. Also, a change in method of accounting does not include adjustment of any item of income or deduction that does not involve the proper time for the inclusion of the item of income or the taking of a deduction. A change in method of accounting also does not include a change in treatment resulting from a change in underlying facts.

New Federal Law

EGTRRA clarifies that a determination of whether contributions to multiemployer pension plans are on account of a prior year under section 404(a)(6) is not a method of accounting. Thus, any taxpayer that begins to deduct contributions to multiemployer plans as provided in section 404(a)(6) has not changed its method of accounting and is not subject to an adjustment under section 481. EGTRRA is intended to respect, not disturb, the effect of the statute of limitations. EGTRRA is not intended to permit, as of the end of the taxable year, aggregate deductions for contributions to a qualified plan in excess of the amounts actually contributed or deemed contributed to the plan by the taxpayer. The Secretary of the Treasury is authorized to promulgate regulations to clarify that, in the aggregate, no taxpayer will be permitted deductions in excess of amounts actually contributed to multiemployer plans, taking into account the provisions of section 404(a)(6).

No inference is intended regarding whether the determination of whether a contribution to a multiemployer pension plan on account of a prior year under section 404(a)(6) is a method of accounting prior to the effective date of the provision.

Effective Date

The provision is effective after June 7, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

Section	Section Title
661	PENSION PLAN - MODIFICATION OF TIMING OF PLAN VALUATIONS.

Background

Under present law, plan valuations are generally required annually for plans subject to the minimum funding rules. Under proposed Treasury regulations, except as provided by the Commissioner, the valuation must be as of a date within the plan year to which the valuation refers or within the month prior to the beginning of that year.

New Federal Law (Sec. 412)

EGTRRA incorporates into the statute the proposed regulation regarding the date of valuations. EGTRRA also provides, as an exception to this general rule, that the valuation date with respect to a plan year may be any date within the immediately preceding plan year if, as of such date, plan assets are not less than 100% of the plan's current liability. Information determined as of such date is required to be adjusted actuarially, in accordance with Treasury regulations, to reflect significant differences in plan participants. A change in funding method to take advantage of the exception to the general rule may not be made unless, as of such date, plan assets are not less than 125% of the plan's current liability. The Secretary is directed to automatically approve changes in funding method to use a prior year valuation date if the change is within the first three years that the plan is eligible to make the change.

Effective Date

The provision is effective for plan years beginning after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

Section	Section Title
662	ESOP DIVIDENDS MAY BE REINVESTED WITHOUT LOSS OF DIVIDEND DEDUCTION

Background

An employer is entitled to deduct certain dividends paid in cash during the employer's taxable year with respect to stock of the employer that is held by an employee stock ownership plan ("ESOP"). The deduction is allowed with respect to dividends that, in accordance with plan provisions, are (1) paid in cash directly to the plan participants or their beneficiaries, (2) paid to the plan and subsequently distributed to the participants or beneficiaries in cash no later than 90 days after the close of the plan year in which the dividends are paid to the plan, or (3) used to make payments on loans (including payments of interest as well as principal) that were used to acquire the employer securities (whether or not allocated to participants) with respect to which the dividend is paid.

The Secretary may disallow the deduction for any ESOP dividend if he determines that the dividend constitutes, in substance, an evasion of taxation (sec. 404(k)(5)).

New Federal Law (Sec. 404)

In addition to the deductions permitted under present law for dividends paid with respect to employer securities that are held by an ESOP, an employer is entitled to deduct dividends that, at the election of plan participants or their beneficiaries, are (1) payable in cash directly to plan participants or beneficiaries, (2) paid to the plan and subsequently distributed to the participants or beneficiaries in cash no later than 90 days after the close of the plan year in which the dividends are paid to the plan, or (3) paid to the plan and reinvested in qualifying employer securities.

EGTRRA permits the Secretary to disallow the deduction for any ESOP dividend if the Secretary determines that the dividend constitutes, in substance, the avoidance or evasion of taxation. This provision includes authority to disallow a deduction of unreasonable dividends.

For purposes of the section 404(k)(2)(A)(iii) reinvested dividends, a dividend paid on common stock that is primarily and regularly traded on an established securities market would be reasonable. In addition, for this purpose in the case of employers with no common stock (determined on a controlled group basis) that is primarily and regularly traded on an established securities market, the reasonableness of a dividend is determined by comparing the dividend rate on stock held by the ESOP with the dividend rate for common stock of comparable corporations whose stock is primarily and regularly traded on an established securities market. Whether a corporation is comparable is determined by comparing relevant corporate characteristics such as industry, corporate size, earnings, debt-equity structure and dividend history.

Effective Date

The provision is effective for taxable years beginning after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

Section	Section Title
663	REPEAL TRANSITION RULE RELATING TO CERTAIN HIGHLY COMPENSATED EMPLOYEES

Background

Under present law, for purposes of the rules relating to qualified plans, a highly compensated employee is generally defined as an employee, including self-employed individuals, who: (1) was a 5% owner of the employer at any time during the year or the preceding year or (2) either (a) had compensation for the preceding year in excess of $85,000 (for 2001) or (b) at the election of the employer, had compensation in excess of $85,000 for the preceding year and was in the top 20% of employees by compensation for such year.

Under a rule enacted in the Tax Reform Act of 1986, a special definition of highly compensated employee applies for purposes of the nondiscrimination rules relating to qualified cash or deferred arrangements ("section 401(k) plans") and matching contributions. This special definition applies to an employer incorporated on December 15, 1924, that meets certain specific requirements.

New Federal Law (Sec. 1114(c)(4) of the Tax Reform Act of 1986)

EGTRRA repeals the special definition of highly compensated employee under the Tax Reform Act of 1986. Thus, the present-law definition applies.

Effective Date

The provision is effective for plan years beginning after December 31, 2001.

California Law

California law did not conform to the highly compensated employee rule enacted by the Tax Reform Act of 1986. Therefore, it is not necessary to repeal the special rule.

Section	Section Title
664	PENSION PLAN - EMPLOYEES OF TAX-EXEMPT ENTITIES.

Background

The Tax Reform Act of 1986 provided that nongovernmental tax-exempt employers were not permitted to maintain a qualified cash or deferred arrangement ("section 401(k) plan"). This prohibition was repealed, effective for years beginning after December 31, 1996, by the Small Business Job Protection Act of 1996.

Treasury regulations provide that, in applying the nondiscrimination rules to a section 401(k) plan (or a section 401(m) plan that is provided under the same general arrangement as the section 401(k) plan), the employer may treat as excludable those employees of a tax-exempt entity who could not participate in the arrangement due to the prohibition on maintenance of a section 401(k) plan by such entities. Such employees may be disregarded only if more than 95% of the employees who could participate in the section 401(k) plan benefit under the plan for the plan year.

Tax-exempt charitable organizations may maintain a tax-sheltered annuity (a "section 403(b) annuity") that allows employees to make salary reduction contributions.

New Federal Law (Sec. 198)

The Treasury Department is directed to revise its regulations under section 410(b) to provide that employees of a tax-exempt charitable organization who are eligible to make salary reduction contributions under a section 403(b) annuity may be treated as excludable employees for purposes of testing a section 401(k) plan, or a section 401(m) plan that is provided under the same general arrangement as the section 401(k) plan of the employer if (1) no employee of such tax-exempt entity is eligible to participate in the section 401(k) or 401(m) plan and (2) at least 95% of the employees who are not employees of the charitable employer are eligible to participate in such section 401(k) plan or section 401(m) plan.

The revised regulations are to be effective for years beginning after December 31, 1996.

Effective Date

The provision is effective on June 7, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

Section	Section Title
665	PENSION PLAN - TREATMENT OF EMPLOYER-PROVIDED RETIREMENT ADVICE.

Background

Under present law, certain employer-provided fringe benefits are excludable from gross income and wages for employment tax purposes. These excludable fringe benefits include working condition fringe benefits and de minimis fringes. In general, a working condition fringe benefit is any property or services provided by an employer to an employee to the extent that, if the employee paid for such property or services, such payment would be allowable as a deduction as a business expense. A de minimis fringe benefit is any property or services provided by the employer the value of which, after taking into account the frequency with which similar fringes are provided, is so small as to make accounting for it unreasonable or administratively impracticable. In addition, if certain requirements are satisfied, up to $5,250 annually of employer-provided educational assistance is excludable from gross income (sec. 127) and wages. This exclusion expires with respect to courses beginning after December 31, 2001. Education not excludable under section 127 may be excludable as a working condition fringe.

There is no specific exclusion under present law for employer-provided retirement planning services. However, such services may be excludable as employer-provided educational assistance or a fringe benefit.

New Federal Law (Sec. 132)

Qualified retirement planning services provided to an employee and his or her spouse by an employer maintaining a qualified plan is excludable from income and wages. The exclusion does not apply with respect to highly compensated employees unless the services are available on substantially the same terms to each member of the group of employees normally provided education and information regarding the employer's qualified plan. “Qualified retirement planning services” are retirement planning advice and information. The exclusion is not limited to information regarding the qualified plan, and, thus, for example, applies to advice and information regarding retirement income planning for an individual and his or her spouse and how the employer's plan fits into the individual's overall retirement income plan. On the other hand, the exclusion does not apply to services that may be related to retirement planning, such as tax preparation, accounting, legal or brokerage services.

It is intended that EGTRRA will clarify the treatment of retirement advice provided in a nondiscriminatory manner. It is intended that the Secretary, in determining the application of the exclusion to highly compensated employees, may permit employers to take into consideration employee circumstances other than compensation and position in providing advice to classifications of employees. Thus, for example, the Secretary may permit employers to limit certain advice to individuals nearing retirement age under the plan.

Effective Date

The provision is effective with respect to years beginning after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

Section	Section Title
666	PENSION PLAN - REPEAL OF THE MULTIPLE USE TEST

Background

Elective deferrals under a qualified cash or deferred arrangement (“section 401(k) plan”) are subject to a special annual nondiscrimination test (“ADP test”). The ADP test compares the actual deferral percentages (“ADPs”) of the highly compensated employee group and the nonhighly compensated employee group. The ADP for each group generally is the average of the deferral percentages separately calculated for the employees in the group who are eligible to make elective deferrals for all or a portion of the relevant plan year. Each eligible employee's deferral percentage generally is the employee's elective deferrals for the year divided by the employee's compensation for the year.

The plan generally satisfies the ADP test if the ADP of the highly compensated employee group for the current plan year is either (1) not more than 125% of the ADP of the nonhighly compensated employee group for the prior plan year, or (2) not more than 200% of the ADP of the nonhighly compensated employee group for the prior plan year and not more than two percentage points greater than the ADP of the nonhighly compensated employee group for the prior plan year.

Employer matching contributions and after-tax employee contributions under a defined contribution plan also is subject to a special annual nondiscrimination test (“ACP test”). The ACP test compares the actual deferral percentages (“ACPs”) of the highly compensated employee group and the nonhighly compensated employee group. The ACP for each group generally is the average of the contribution percentages separately calculated for the employees in the group who are eligible to make after-tax employee contributions or who are eligible for an allocation of matching contributions for all or a portion of the relevant plan year. Each eligible employee's contribution percentage generally is the employee's aggregate after-tax employee contributions and matching contributions for the year divided by the employee's compensation for the year.

The plan generally satisfies the ACP test if the ACP of the highly compensated employee group for the current plan year is either (1) not more than 125% of the ACP of the nonhighly compensated employee group for the prior plan year, or (2) not more than 200% of the ACP of the nonhighly compensated employee group for the prior plan year and not more than two percentage points greater than the ACP of the nonhighly compensated employee group for the prior plan year.

For any year in which (1) at least one highly compensated employee is eligible to participate in an employer's plan or plans that are subject to both the ADP test and the ACP test, (2) the plan subject to the ADP test satisfies the ADP test but the ADP of the highly compensated employee group exceeds 125% of the ADP of the nonhighly compensated employee group, and (3) the plan subject to the ACP test satisfies the ACP test but the ACP of the highly compensated employee group exceeds 125% of the ACP of the nonhighly compensated employee group, an additional special nondiscrimination test (“multiple use test”) applies to the elective deferrals, employer matching contributions, and after-tax employee contributions. The plan or plans generally satisfy the multiple use test if the sum of the ADP and the ACP of the highly compensated employee group does not exceed the greater of (1) the sum of (A) 1.25 times the greater of the ADP or the ACP of the nonhighly compensated employee group, and (B) two percentage points plus (but not more than two times) the lesser of the ADP or the ACP of the nonhighly compensated employee group, or (2) the sum of (A) 1.25 times the lesser of the ADP or the ACP of the nonhighly compensated employee group, and (B) two percentage points plus (but not more than two times) the greater of the ADP or the ACP of the nonhighly compensated employee group.

New Federal Law (Sec. 401(m))

The provision repeals the multiple use test.

Effective Date

The provision is effective for years beginning after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

Appendix II
SB 657 (Scott)
Conformity to 1998 – 2000 Federal Changes

1. Exclusion from Income for Employer-Provided Transportation Benefits

Under federal and California laws, qualified transportation fringe benefits provided by an employer are excluded from an employee's gross income. Qualified transportation fringe benefits include parking, transit passes, and vanpool benefits. In addition, in the case of employer-provided parking, no amount is includible in income of an employee merely because the employer offers the employee a choice between cash and employer-provided parking. Under prior federal and current California laws, transit passes and vanpool benefits were excludable only if provided in addition to, and not in lieu of, any compensation otherwise payable to an employee. Up to $155 per month of employer-provided parking was excludable from income. Up to $60 per month of employer-provided transit and vanpool benefits were excludable from gross income. These dollar amounts were indexed annually for inflation, rounded to the nearest multiple of $5.

Under current and prior federal and state laws, qualified transportation fringe benefits include a cash reimbursement by an employer to an employee. However, in the case of transit passes, a cash reimbursement is considered a qualified transportation fringe benefit only if a voucher or similar item which may be exchanged only for a transit pass is not readily available for direct distribution by the employer to the employee.

Under the Transportation Act, employers are permitted to offer employees a choice between cash compensation or any qualified transportation benefit or a combination of any of such benefits. The amount of cash offered is includible in income and wages only to the extent the employee elects cash. Thus, under the provision, no amount is includible in gross income or wages merely because the employee is offered the choice of cash in lieu of one or more qualified transportation benefits (up to the applicable dollar limit). Also, no amount is includible in income or wages merely because the employee is offered a choice among qualified transportation benefits.

It is intended that salary reduction amounts used to provide qualified transportation benefits under the provision be treated for pension plan purposes the same as other salary reduction contributions.

The Transportation Act increased the exclusion for employer-provided parking to $175 per month and the employer-provided transit and vanpool benefits exclusion to $65 per month. In addition, beginning in 2002, the Transportation Act increases the exclusion for transit passes and vanpooling to $100 per month. Beginning in 2003, the $100 amount is indexed as under prior law. Further, no qualified transportation benefit will be indexed in 1999.

The provision permitting a cash option for any transportation benefit is effective for taxable years beginning after December 31, 1997; the increase in the exclusion for transit passes and vanpooling to $100 per month is effective for taxable years beginning after December 31, 2001; and indexing on the $100 amount for transit passes and vanpooling is effective for taxable years beginning after December 31, 2002.

California Law

Current California law is in full conformity with federal law as it read on January 1, 1998, as it relates to qualified transportation fringe benefits and annual additions to tax-qualified pension plans.

In addition, California law provides that gross income of an employee does not include benefits received for participation in any ridesharing arrangement in California. A ridesharing arrangement includes:

- commuting in a carpool, vanpool, bus pool, or taxi pool.
- monthly transit passes used by the employee or the employee's dependents, other than dependents attending elementary or secondary school.
- free or subsidized parking.
- commuting by ferry or bicycling.
- travel to or from a telecommuting facility.
- the use of any transportation used to go to or from the place of employment that reduces the use of a motor vehicle occupied by a single person.

This bill would conform California law to the Transportation Act changes to the transportation fringe benefits rules. This bill would not affect the rules relating to California ridesharing arrangements.

2. Deductibility of Meals Provided for the Convenience of the Employer

In general, subject to several exceptions, only 50% of the cost of business meals and entertainment is allowed as a deduction IRC Sec. 274(n)). Under the Tax Relief and Reform Act of 1997 (TRA of 1997) exception, meals excludable from employees' incomes as a de minimis fringe benefit (IRC Sec. 132) are fully deductible by the employer. In addition, the courts have held that if substantially all of the meals are provided for the convenience of the employer pursuant to IRC Sec. 119, the cost of such meals is fully deductible because the employer is treated as operating a de minimis eating facility within the meaning of IRC Sec. 132(e)(2). However, the judicial decisions did not provide a bright line definition of "substantially all," and thus disputes continued between taxpayers and the IRS.

The IRS Reform Act provides a new safe harbor rule for the employee exclusion and the employer deduction. Under that new safe harbor, all meals furnished to employees at the employer's place of business meet the convenience test under IRC Sec. 119, if more than one-half of employees furnished meals on the premises are furnished such meals for the convenience of the employer. If these conditions are satisfied, the value of all such meals are excludable from the employee's income and fully deductible to the employer. No inference is intended as to whether the cost of such meals are fully deductible under prior law. This provision is effective for all taxable years. The provision is effective for taxable years for which the applicable statute of limitations has not expired.

California Law

California law is in full conformity with federal law as it read on January 1, 1998, as it relates to the deduction of meals provided to employees.

This bill would conform California law with the new federal safe harbor rule as it relates to the deductibility of meals provided by an employer with the same effective date as under federal law.

3. Employer Deductions for Vacation and Severance Pay

Under prior federal and current California laws, for deduction purposes, any method or arrangement that has the effect of a plan deferring the receipt of compensation or other benefits for employees is treated as a deferred compensation plan (IRC Sec. 404(b)). In general, contributions under a deferred compensation plan (other than certain pension, profit-sharing and similar plans) are deductible in the taxable year in which an amount attributable to the contribution is includible in income of the employee, regardless of whether the employee actually receives the benefit during the year. However, vacation pay which is treated as deferred compensation is deductible for the taxable year of the employer in which the vacation pay is paid to the employee (IRC Sec. 404(a)(5)).

Temporary Treasury regulations provide that a plan, method, or arrangement defers the receipt of compensation or benefits if an employee receives compensation or benefits more than a brief period of time after the end of the employer's taxable year in which the services creating the right to such compensation or benefits are performed. Compensation received after the 15th day of the third calendar month after the end of the employer's taxable year in which the related services are rendered is considered received after more than a brief period. Compensation or benefits received by the employee on or before the end of the applicable 2 1/2- month period is not deferred compensation. (Temp. Treas. Reg. Sec. 1.404(b)-1T, A-2.)

The Tax Court recently addressed the issue of when vacation pay and severance pay are considered deferred compensation in Schmidt Baking Co., Inc. v. Commissioner (1996) 107 T.C. 271. In Schmidt Baking, the taxpayer was an accrual basis taxpayer with a fiscal year that ended December 28, 1991. The taxpayer funded its accrued vacation and severance pay liabilities for 1991 by purchasing an irrevocable letter of credit on March 13, 1992. The parties stipulated that the letter of credit represented a transfer of a substantially vested interest in property to employees for purposes of Section 83, and that the fair market value of such interest was includible in the employees' gross incomes for 1992 as a result of the transfer. While the rules of Section 83 may govern the income inclusion for employees, Section 404 governs the employer deduction if the amount involved is deferred compensation.

The Tax Court held that the purchase of the letter of credit, and the resulting income inclusion, constituted payment of the vacation and severance pay within the 2 1/2-month period. Thus, the vacation and severance pay were treated as received by the employees within the 2 1/2-month period and were not treated as deferred compensation. The vacation pay and severance pay were deductible by the taxpayer-employer for its 1991 fiscal year pursuant to its normal accrual method of accounting.

The IRS Reform Act provided that for purposes of determining whether an item of compensation is deferred compensation (under IRC Sec. 404), the compensation is not considered to be paid or received until actually received by the employee.

In addition, an item of deferred compensation is not considered paid to an employee until actually received by the employee. The provision is intended to overrule the result in Schmidt Baking. For example, with respect to the determination of whether vacation pay is deferred compensation, the fact that the value of the vacation pay is includible in the income of employees within the applicable 2 1/2-month period is not relevant. Rather, the vacation pay must have been actually received by employees within the 2 1/2-month period for the compensation not to be treated as deferred compensation.

Congress intended that similar arrangements, in addition to the letter of credit approach used in Schmidt Baking, do not constitute actual receipt by the employee, even if there is an income inclusion. Thus, for example, actual receipt does not include the furnishing of a note or letter or other evidence of indebtedness of the taxpayer, regardless of whether the evidence is guaranteed by any other instrument or by any third party. As a further example, actual receipt does not include a promise of the taxpayer to provide service or property in the future (regardless of whether the promise is evidenced by a contract or other written agreement).

In addition, actual receipt does not include an amount transferred as a loan, refundable deposit, or contingent payment. Amounts set aside in a trust for employees generally are not considered to be actually received by the employee.

The provision does not change the rule under which deferred compensation (other than vacation pay and sick pay and deferred compensation under qualified plans) is deductible in the year includible in the gross income of employees participating in the plan if separate accounts are maintained for each employee.

While Schmidt Baking involved only vacation pay and severance pay, there is concern that this type of arrangement may be used to try to circumvent other provisions of the IRC where payment is required in order for a deduction to occur. Thus, Congress expressed its intent that the Secretary will prevent the use of similar arrangements, though no inference was intended that the result in Schmidt Baking is present law beyond its immediate facts or that the use of similar arrangements is permitted under present law.

This provision is effective under federal law for taxable years ending after July 22, 1998. Any change in a taxpayer's method of accounting required by this provision will be treated as initiated by the taxpayer with the consent of the Secretary of the Treasury. Any adjustment required by IRC Sec. 481 as a result of the change will be taken into account for federal purposes over a three-year period beginning with the first year for which the provision is effective.

California Law

Current California law is in full conformity with federal law as it read on January 1, 1998, as it relates to employer deductions for vacation and severance pay.

This bill would conform California law to the federal IRS Reform Act law change as it relates to the accrual of vacation and severance pay. This bill would also require any state adjustment required by IRC Sec.481 as a result of the change to be taken into account over a three-year period beginning with 2002.

4. Certain Trade Receivables Ineligible for Mark-To-Market Treatment

In general, under federal and state laws, dealers in securities are required to use a mark-to-market method of accounting for securities (IRC Sec. 475). Exceptions to the mark-to-market rule are provided for securities held for investment, certain debt instruments and obligations to acquire debt instruments and certain securities that hedge securities. A dealer in securities is a taxpayer who regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or who regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in certain types of securities with customers in the ordinary course of a trade or business.

A security includes (1) a share of stock, (2) an interest in a widely held or publicly traded partnership or trust, (3) an evidence of indebtedness, (4) an interest rate, currency, or equity notional principal contract, (5) an evidence of an interest in, or derivative financial instrument in, any of the foregoing securities, or any currency, including any option, forward contract, short position, or similar financial instrument in such a security or currency, or (6) a position that is an identified hedge with respect to any of the foregoing securities.

The IRS Reform Act provides that certain trade receivables are not eligible for mark-to-market treatment. A trade receivable is covered by the provision if it is a note, bond or debenture arising out of the sale of goods by a person the principal activity of which is selling or providing nonfinancial goods and services and it is held by such person or a related person at all times since it was issued.

Under the IRS Reform Act, a receivable meeting the above definition is not treated as a security for purposes of the mark-to-market rules (IRC Sec. 475). Thus, such receivables are not marked-to-market, even if the taxpayer qualifies as a dealer in other securities. A taxpayer will not be treated as a dealer in securities based on sales to unrelated persons of receivables subject to the new provision unless the regulatory exception for receivables held for sale to customers applies.

The IRS Reform Act provision also applies to trade receivables arising from services performed by independent contractors, as well as employees. Thus, for example, if a taxpayer's principal activity is selling non-financial services and some or all of such services are performed by independent contractors, no receivables that the taxpayer accepts for services can be marked-to-market under the new provision.

Pursuant to the authority granted by IRC Sec. 475(g)(1), the Secretary of the Treasury is authorized to issue regulations to prevent abuse of the new exception, including through independent contractor arrangements.

The provision provides that, to the extent provided in Treasury regulations, trade receivables that are held for sale to customers by the taxpayer or a related person may be treated as "securities" for purposes of the mark-to-market rules, and transactions in such receivables could result in a taxpayer being treated as a dealer in securities (IRC Sec. 475(c)(1)).

For trade receivables that are excepted from the statutory mark-to-market rules (IRC Sec. 475) under the new provision, mark-to-market or lower-of-cost-or-market will not be treated as methods of accounting that clearly reflect income under general tax principles (see IRC Sec. 446(b)).

The provision generally is effective for taxable years ending after July 22, 1998. Adjustments required under IRC Sec. 481 as a result of the change in method of accounting generally are required to be taken into account for federal purposes ratably over the four-year period beginning in the first taxable year for which the provision is in effect.

California Law

Current California law is in full conformity with federal law as it read on January 1, 1998, as it relates to the "mark to market" method of accounting.

This bill would conform California law to federal law as its relates to "mark to market" method of accounting for dealers. This bill would also require adjustments under IRC Sec. 481 as a result of the change in method of accounting to be taken into account for state purposes ratably over a three-year period beginning in 2002.

5. Exclusion of Minimum Required Distributions from AGI for Roth IRA Conversions

Under federal and California laws, uniform minimum distribution rules generally apply to all types of tax-favored retirement vehicles, including qualified retirement plans and annuities, individual retirement arrangements (IRAs) other than Roth IRAs, and tax-sheltered annuities (IRC Sec. 403(b)).

Under federal and California laws, distributions for IRAs must begin no later than April 1st of the calendar year following the calendar year in which the IRA owner attains age 70½. The IRS has issued extensive regulations for purposes of calculating minimum distributions. In general, minimum distributions are includible in gross income in the year of distribution. An excise tax equal to 50% of the required distribution applies to the extent a required distribution is not made.

Under federal and California laws, all or any part of amounts in a deductible or nondeductible IRA may be converted into a Roth IRA. Only taxpayers with modified adjusted gross income (AGI) of $100,000 or less for the year of the conversion are eligible to convert an IRA into a Roth IRA. In the case of a married taxpayer, AGI is the combined AGI of the couple.

The IRS Reform Act, for taxable years beginning after December 31, 2004, excludes minimum required distributions from IRAs for taxpayers 70½ years or older from the definition of modified AGI solely for purposes of determining eligibility to convert from an IRA to a Roth IRA. As under present law, the required minimum distribution would not be eligible for conversion and would be includible in gross income.

Current California law is in full conformity with federal law as it read on January 1, 1998, as it relates to Roth IRAs, except for the required minimum distribution exclusion.

This bill would conform California law with federal law as it relates to exclusion of required minimum distributions from modified AGI for purposes of Roth IRA conversions. The operative date of this provision is for taxable years beginning after December 31, 2004 (the federal operative date).

6. Farm Production Flexibility Contract Payments

Under federal and California laws, a taxpayer generally is required to include an item in income no later than the time of its actual or constructive receipt, unless such amount is properly accounted for in a different period under the taxpayer's method of accounting. If a taxpayer has an unrestricted right to demand the payment of an amount, the taxpayer is in constructive receipt of that amount regardless of whether the taxpayer actually receives the payment.

The Federal Agriculture Improvement and Reform Act of 1996 (the FAIR Act) provides for production flexibility contracts between certain eligible owners and producers and the Secretary of Agriculture. These contracts generally cover crop years from 1996 through 2002.

Annual payments are made under such contracts at specific times during the federal government's fiscal year. Section 112(d)(2) of the FAIR Act provides that one-half of each annual payment is to be made on either December 15th or January 15th of the fiscal year, at the option of the recipient. This option to receive the payment on December 15th potentially results in the constructive receipt (and thus potential inclusion in income) of one-half of the annual payment at that time, even if the option to receive the amount on January 15th is elected.

The remaining one-half of the annual payment must be made no later than September 30th of the fiscal year. The Emergency Farm Financial Relief Act of 1998 added Section 112(d)(3) to the FAIR Act, which provides that all payments for fiscal year 1999 are to be paid at such time or times during fiscal year 1999 as the recipient may specify. Thus, the one-half of the annual amount that would otherwise be required to be paid no later than September 30, 1999, can be specified for payment in calendar year 1998. This potentially results in the constructive receipt (and thus required inclusion in taxable income) of such amounts in calendar year 1998, regardless of whether the amounts actually are received or the right to their receipt is fixed.

Under the Tax and Trade Extension Act, the time a production flexibility contract payment under the FAIR Act is properly includible in income would be determined without regard to the options granted by Section 112(d)(2) (allowing receipt of one-half of the annual payment on either December 15th or January 15th of the fiscal year) or Section 112(d)(3)(allowing the acceleration of all payments for fiscal year 1999) of that Act. The provision is effective for production flexibility contract payments made under the FAIR Act in taxable years ending after December 31, 1995.

California Law

Current California law follows federal law in regards to the tax accounting concept of "constructive receipt." Therefore, the time a production flexibility contract payment received under the FAIR Act properly is includible in income would be determined by taking into account the options granted under the FAIR Act.

This bill would conform California law with federal law as it relates to farm production flexibility payments with the same effective date with respect to payments received in taxable and income years ending after December 31, 1995.

7. Treatment of Certain Deductible Liquidating Distributions of RICs/REITs

Regulated investment companies (RICs) and real estate investment trusts (REITs) are allowed a deduction for dividends paid to their shareholders. The deduction for dividends paid includes amounts distributed in liquidation that are properly chargeable to earnings and profits. In the case of a complete liquidation occurring within 24 months after the adoption of a plan of complete liquidation, the deduction includes any distribution made pursuant to the plan to the extent of earnings and profits. Rules that govern the receipt of dividends from RICs and REITs generally provide for including the amount of the dividend in the income of the shareholder receiving the dividend that was deducted by the RIC or REIT. Generally, any shareholder realizing gain from a liquidating distribution of a RIC or REIT includes the amount of gain in the shareholder's income.

However, in the case of a liquidating distribution to a corporation owning 80% of the stock of the distributing corporation, a separate rule generally provides that the distribution is tax-free to the parent corporation. The parent corporation succeeds to the tax attributes, including the adjusted basis of assets distributed. Under these rules, a liquidating RIC or REIT might be allowed a deduction for amounts paid to its parent corporation, without a corresponding inclusion in the income of the parent corporation, resulting in income not being subject to tax.

A RIC or REIT may designate a portion of a dividend as a capital gain dividend to the extent the RIC or REIT itself has a net capital gain. A RIC may designate a portion of the dividend paid to a corporate shareholder as eligible for the 70% dividends-received deduction to the extent the RIC itself received dividends from other corporations. If certain conditions are satisfied, a RIC also is permitted to pass through to its shareholders the tax-exempt character of the RIC's net income from tax-exempt obligations through the payment of "exempt interest dividends," though no deduction is allowed for such dividends.

The Tax and Trade Extension Act provides that any amount which a liquidating RIC or REIT may take as a deduction for dividends paid with respect to an otherwise tax-free liquidating distribution to an 80% corporate owner is includible in the income of the recipient corporation. The includible amount is treated as a dividend received from the RIC or REIT. The liquidating corporation may designate the amount distributed as a capital gain dividend or, in the case of a RIC, a dividend eligible for the 70% dividends received deduction or an exempt interest dividend, to the extent provided by the RIC or REIT provisions of the IRC.

The Tax and Trade Extension Act does not otherwise change the tax treatment of the distribution to the parent corporation or to the RIC or REIT. Thus, for example, the liquidating corporation will not recognize gain (if any) on the liquidating distribution and the recipient corporation will hold the assets at a carryover basis, even where the amount received is treated as a dividend. The provision is effective for distributions on or after May 22, 1998, regardless of when the plan of liquidation was adopted. No inference is intended regarding the treatment of such transactions under present law.

California Law

Current California law conforms to the federal treatment of RICs and REITs with certain modifications. California is conformed to the federal treatment of a liquidating distribution from a RIC or a REIT prior to the enactment of the Tax and Trade Extension Act. However, California has not conformed to the modification made by IRS Reform Act Section 6012(g) relating to "earnings and profits" ordinary distributions of REITs.

This bill would conform California law with federal law as it relates to liquidating distributions from RICs and REITs, effective for distributions made on or after January 1, 2000. This bill would not conform California law with federal law as it relates to “earnings and profits" ordinary distributions of REITs.

8. Tax Treatment of Cash Options for Qualified Prizes

Under federal and California laws, a taxpayer generally is required to include an item in income no later than the time of its actual or constructive receipt, unless the item properly is accounted for in a different period under the taxpayer's method of accounting. If a taxpayer has an unrestricted right to demand payment of an amount, the taxpayer is in constructive receipt of that amount regardless of whether the taxpayer makes the demand and actually receives the payment. Under the principle of constructive receipt, the winner of a contest who is given the option of receiving either a lump-sum distribution or an annuity after winning the contest is required to include the value of the award in gross income, even if the annuity option is exercised.

Under the Tax and Trade Extension Act, the existence of a "qualified prize option" is disregarded in determining the taxable year for which any portion of a qualified prize is to be included in income. A qualified prize option is an option that entitles a person to receive a single cash payment in lieu of a qualified prize (or portion thereof), provided such option is exercisable not later than 60 days after the prize winner becomes entitled to the prize.

Thus, a qualified prize winner who may choose either cash or an annuity not later than 60 days after becoming entitled to the prize is not required to include amounts in gross income immediately if the annuity option is exercised. This provision applies with respect to any qualified prize to which a person first becomes entitled after October 21, 1998.

In addition, the Tax and Trade Extension Act also applies to any qualified prize to which a person became entitled on or before October 21, 1998, if the person has an option to receive a lump-sum cash payment only during some portion of the 18-month period beginning on July 1, 1999. This is intended to give previous prize winners a one-time option to alter previous payment arrangements.

Qualified prizes are prizes or awards from contests, lotteries, jackpots, games or similar arrangements that provide a series of payments over a period of at least 10 years, provided that the prize or award does not relate to any past services performed by the recipient and do not require the recipient to perform any substantial future service. Appearing in advertising relating to the prize or award is not (in and of itself) treated as substantial. The provision applies to individuals on the cash receipts and disbursements method of accounting. Income and deductions resulting from this provision retain their character as ordinary, not capital. In addition, the Secretary is to provide for the application of this provision in the case of a partnership or other pass-through entity consisting entirely of individuals on the cash receipts and disbursements method of accounting.

Any offer of a qualified prize option must include disclosure of the method used to compute the single cash payment, including the discount rate that makes equivalent the present values of the prize (or relevant portion thereof) and the single cash payment offered. Any offer of a qualified prize option must also clearly indicate that the prize winner is under no obligation to accept a single cash payment and may continue to receive the payments to which he or she is entitled under the terms of the qualified prize.

California Law

Current California law is generally conformed to federal law as of January 1, 1998, as it relates to the taxation of awards and prizes. California law specifically exempts California lottery winnings from taxable income for state purposes.

This bill would conform California law with federal law as it relates to the treatment of prizes other than California lottery winnings.

9. Payments Received Pursuant to the Ricky Ray Hemophilia Relief Fund Act

Generally, gross income does not include any damages received (whether by suit or agreement and whether as lump sum or as periodic payments) on account of a personal physical injury or physical sickness (IRC Sec. 104(a)(2)). If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) are treated as payments received on account of physical injury or physical sickness regardless of whether the recipient of the damages is the injured party.

The term "damages received whether by suit or agreement" is defined under Treasury regulations to mean an amount received (other than workmen's compensation) through prosecutions of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution. Under prior law, payments not meeting the requirements of IRC Sec. 104 were not excludable from income under that section.

The Ricky Ray Hemophilia Act treats payments to certain individuals with blood-clotting disorders who contracted the human immunodeficiency virus (HIV) due to contaminated blood products as damages received on account of personal physical injury or physical sickness described in IRC Sec. 104(a)(2). Thus, such payments made to individuals are excluded from gross income.

California Law

Current California law is in full conformity with federal law as it read on January 1, 1998, as it relates to the exclusion from income any damages received on account of a personal physical injury or physical sickness.

This bill would conform California law with federal treatment of payments received pursuant to the Ricky Ray Hemophilia Relief Fund Act.

10. Property Subject to a Liability Treated as Assumption of Liability

Prior federal and state laws provided that the transferor of property recognized no gain or loss if the property is exchanged solely for qualified stock in a controlled corporation (IRC Sec. 351). The assumption by the controlled corporation of a liability of the transferor (or the acquisition of property “subject to” a liability) generally did not cause the transferor to recognize gain.

However, under IRC Sec. 357(c), the transferor does recognize gain to the extent that the sum of the assumed liabilities, together with the liabilities to which the transferred property is subject, exceeds the transferor's basis in the transferred property. If the transferred property is “subject to” a liability, Treasury regulations indicate that the amount of the liability is included in the calculation regardless of whether the underlying liability is assumed by the controlled corporation. Similar rules apply to reorganizations described in IRC Sec. 368(a)(1)(D).

The gain recognition rule of IRC Sec. 357(c) is applied separately to each transferor in an IRC Sec. 351 exchange.

The basis of the property in the hands of the controlled corporation equals the transferor's basis in such property, increased by the amount of gain recognized by the transferor, including IRC Sec. 357(c) gain.

Under the Miscellaneous Trade and Technical Corrections Act of 1999, the distinction between the assumption of a liability and the acquisition of an asset subject to a liability generally is eliminated.

In general, a recourse liability (or any portion thereof) is treated as having been assumed if, as determined on the basis of all facts and circumstances, the transferee has agreed to, and is expected to satisfy the liability or portion thereof (regardless of whether the transferor has been relieved of the liability). Thus, where more than one person agrees to satisfy a liability or portion thereof, only one would be expected to satisfy such liability or portion thereof.

Also, a nonrecourse liability (or any portion thereof) is treated as having been assumed by the transferee of any asset that is subject to the liability. However, this amount is reduced in cases where an owner of other assets subject to the same nonrecourse liability agrees with the transferee to, and is expected to, satisfy the liability (up to the fair market value of the other assets, determined without regard to IRC Sec. 7701(g)).

In determining whether any person has agreed to and is expected to satisfy a liability, all facts and circumstances are to be considered. In any case where the transferee does agree to satisfy a liability, the transferee also will be expected to satisfy the liability in the absence of facts indicating the contrary.

In determining any increase to the basis of property transferred to the transferee as a result of gain recognized because of the assumption of liabilities under IRC Sec. 357, in no event will the increase cause the basis to exceed the fair market value of the property (determined without regard to IRC Sec. 7701(g)).

If gain is recognized to the transferor as the result of an assumption by a corporation of a nonrecourse liability that also is secured by any assets not transferred to the corporation, and if no person is subject to federal income tax on such gain, then for purposes of determining the basis of assets transferred, the amount of gain treated as recognized as the result of such assumption of liability shall be determined as if the liability assumed by the transferee equaled such transferee's ratable portion of the liability, based on the relative fair market values (determined without regard to IRC Sec. 7701(g)) of all assets subject to such nonrecourse liability.

In no event will the gain cause the resulting basis to exceed the fair market value of the property (determined without regard to IRC Sec. 7701(g)).

The Treasury Department has authority to prescribe such regulations as may be necessary to carry out the purposes of the provision. This authority includes the authority to specify adjustments in the treatment of any subsequent transactions involving the liability, including the treatment of payments actually made with respect to any liability as well as appropriate basis and other adjustments with respect to such payments. Where appropriate, the Treasury Department also may prescribe regulations which provide that the manner in which a liability is treated as assumed under the provision is applied elsewhere in the IRC.

California Law

Current state law conforms with federal law as it relates to the transfer of assets to a controlled corporation prior to the passage of the Miscellaneous Trade and Technical Corrections Act Of 1999.

This bill would conform state law to the Miscellaneous Trade and Technical Corrections Act of 1999 by eliminating the distinction between the assumption of a liability and the acquisition of an asset subject to a liability for transfers on or after January 1, 2002.

11. Extend Tentative Minimum Tax Relief for Individuals

Federal law provides for certain nonrefundable personal tax credits (i.e., the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child tax credit, the credit for interest on certain home mortgages, the HOPE Scholarship and Lifetime Learning credits, and the D.C. homebuyer's credit). Except for taxable years beginning during 1998, these credits are allowed only to the extent that the individual's regular income tax liability exceeds the individual's tentative minimum tax (TMT), determined without regard to the minimum tax foreign tax credit.

For taxable years beginning during 1998, these credits are allowed to the extent of the full amount of the individual's regular tax (without regard to TMT).

The Ticket to Work and Work Incentives Improvement Act of 1999 extends to taxable years beginning in 1999 the provision that allows the personal nonrefundable credits to offset the individual's regular tax liability in full (as opposed to only the amount by which the regular tax exceeds TMT).

For taxable years beginning in 2000 and 2001, the personal nonrefundable credits may offset both the regular tax and the alternative minimum tax (AMT). The foreign tax credit will be allowed before the personal credits in computing the regular tax for these years. The refundable child credit will not be reduced by the amount of an individual's minimum tax in taxable years beginning in 1999, 2000, and 2001.

California Law

Current state law is generally in conformity with federal law as it relates to the computation of AMT and TMT as well as the limitation of credits to the excess of regular tax over TMT. The amounts included in the computation may differ due to other differences in the laws such as the threshold amounts and the California AMT rate of 7%.

Prior to AB 1637 (Stats. 1999, Ch. 930,), the only “personal” type credit allowed to reduce the regular tax amount below TMT was the renter’s credit.

Starting in the 1999 tax year, AB 1637 eliminated the TMT limitation on personal exemption credits by allowing the “exemption” credits to reduce regular tax below TMT.

“Exemption” credits are the personal, dependent, blind and senior credits only. California law still limits other “personal” type credits to the excess of regular tax over TMT.

Other “personal” type credits are the joint custody head of household, dependent parent, senior head of household and child adoption credits. The senior head of household and child adoption credits have AGI limitations. The interaction of the AGI limitations and the AMT threshold amounts reduce the number of taxpayers taking one of these two credits being affected by the TMT limitation.

Starting in the 2002 taxable year, this bill would eliminate the TMT limitation on the joint custody head of household, dependent parent, senior head of household and child adoption credits.

12. Extend Expensing of Environmental Remediation Expenditures

Under federal and state laws, taxpayers can elect to treat certain environmental remediation expenditures that would otherwise be chargeable to capital account as deductible in the year paid or incurred (IRC Sec. 198). The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site. A "qualified contaminated site" generally is any property that (1) is held for use in a trade or business, for the production of income, or as inventory; (2) is certified by the appropriate state environmental agency to be located within a targeted area; and (3) contains (or potentially contains) a hazardous substance (so-called "brownfields").

Targeted areas are defined as: (1) empowerment zones and enterprise communities as designated under present law; (2) sites announced before February, 1997, as being subject to one of the 76 Environmental Protection Agency (EPA) Brownfields Pilots; (3) any population census tract with a poverty rate of 20% or more; and (4) certain industrial and commercial areas that are adjacent to tracts described in (3) above. However, sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 cannot qualify as targeted areas. Eligible expenditures are those paid or incurred before January 1, 2001.

The Ticket to Work and Work Incentives Improvement Act of 1999 extended the expiration date of December 31, 2000 for IRC Section 198 to include those expenditures paid or incurred before January 1, 2002. The Appropriations Act, 2001, extended the above mentioned treatment to expenditures incurred before January 1, 2004.

In addition, the Appropriations Act, 2001 eliminated the targeted area requirement, thereby expanding eligible sites to include any site containing (or potentially containing) a hazardous substance that is certified by the appropriate state environmental agency. However, expenditures undertaken at sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 would continue to not qualify as eligible expenditures.

California Law

California is in conformity with federal law as it relates to environmental remediation expenditures; however, as under prior federal law, the provision applies only to expenditures paid or incurred before January 1, 2001. In addition, an election to deduct remediation expenditures for federal purposes is applicable for California purposes. No separate election is allowed.

This bill would conform state law to the federal extension of the expiration date to include those expenditures paid or incurred on or after January 1, 2002 and before January 1, 2004.

13. Provide that Federal Production Payments Are Taxable in the Year Received

Under federal and state laws, a taxpayer generally is required to include an item in income no later than the time of its actual or constructive receipt, unless such amount properly is accounted for in a different period under the taxpayer's method of accounting. If a taxpayer has an unrestricted right to demand the payment of an amount, the taxpayer is in constructive receipt of that amount regardless of whether the taxpayer makes the demand and actually receives the payment.

The Federal Agriculture Improvement and Reform Act of 1996 (the FAIR Act) provides for production flexibility contracts between certain eligible owners and producers and the Secretary of Agriculture. These contracts generally cover crop years from 1996 through 2002. Annual payments are made under such contracts at specific times during the federal government's fiscal year. Section 112(d)(2) of the FAIR Act provides that one-half of each annual payment is to be made on either December 15 or January 15 of the fiscal year, at the option of the recipient. The remaining one-half of the annual payment must be made no later than September 30 of the fiscal year. The Emergency Farm Financial Relief Act of 1998 added Section 112(d)(3) to the FAIR Act, which provides that all payments for fiscal year 1999 are to be paid at such time or times during fiscal year 1999 as the recipient may specify. Thus, the one-half of the annual amount that would otherwise be required to be paid no later than September 30, 1999, can be specified for payment in calendar year 1998.

These options potentially would have resulted in the constructive receipt (and thus inclusion in income) of the payments to which they relate at the time they could have been exercised, regardless of whether they were in fact exercised. However, Section 2012 of the Tax and Trade Relief Extension Act of 1998 provided that the time a production flexibility contract payment under the FAIR Act properly is includible in income is to be determined without regard to either option, effective for production flexibility contract payments made under the FAIR Act in taxable years ending after December 31, 1995.

The Ticket to Work and Work Incentives Improvement Act of 1999 provides that any unexercised option to accelerate the receipt of any payment under a production flexibility contract payable under the FAIR Act, as in effect on December 17, 1999, is disregarded in determining the taxable year in which such payment is properly included in gross income. Options to accelerate payments that are enacted in the future are covered by this rule, providing the payment to which they relate is mandated by the FAIR Act as in effect on December 17, 1999. The provision does not delay the inclusion of any amount in gross income beyond the taxable period in which the amount is received.

California Law

Current state law follows federal law as it read on January 1, 1998, in regards to the tax accounting concept of “constructive receipt.” Therefore, the time a production flexibility contract payment received under the FAIR Act is properly includible in income would be determined by taking into account the options granted under the FAIR Act.

This bill would conform state law to the new federal rule, which provides that any unexercised option under the FAIR Act is disregarded in determining the taxable or income year in which that payment is properly included in gross income.

14. Clarify the Tax Treatment of Income and Losses from Derivatives

Under federal and state laws, capital gain treatment applies to gain on the sale or exchange of a capital asset.

Capital assets include property other than (1) stock in trade or other types of assets includible in inventory, (2) property used in a trade or business that is real property or property subject to depreciation, (3) accounts or notes receivable acquired in the ordinary course of a trade or business, (4) certain copyrights (or similar property), and (5) U.S. government publications. Gain or loss on such assets generally is treated as ordinary income or loss, rather than capital gain or loss. Certain other provisions also treat gains or losses as ordinary income or loss. For example, the gains or losses of securities dealers or certain electing commodities dealers or electing traders in securities or commodities that are subject to "mark-to-market" accounting are treated as ordinary income or loss (IRC Sec. 475).

Treasury regulations (which were finalized in 1994) require ordinary income or loss character treatment for most business hedges and provide timing rules requiring that gains or losses on hedging transactions be taken into account in a manner that matches the income or loss from the hedged item or items. The regulations apply to hedges that meet a standard of "risk reduction" with respect to ordinary property held (or to be held) or certain liabilities incurred (or to be incurred) by the taxpayer and that meet certain identification and other requirements (Treas. Reg. Sec. 1.1221-2).

Effective for any instrument held, acquired, or entered into, any transaction entered into, and supplies held or acquired on or after December 17, 1999, the Ticket to Work and Work Incentives Improvement Act of 1999 adds three categories to the list of assets the gain or loss on which is treated as ordinary (IRC Sec. 1221) income or loss.

The new categories are: (1) commodities derivative financial instruments held by commodities derivatives dealers; (2) hedging transactions; and (3) supplies of a type regularly consumed by the taxpayer in the ordinary course of a taxpayer's trade or business. In defining a hedging transaction, the provision generally codifies the approach taken by the Treasury regulations, but modifies the rules. The "risk reduction" standard of the regulations is broadened to "risk management" with respect to ordinary property held (or to be held) or certain liabilities incurred (or to be incurred). Additionally, the Act provides that the definition of a hedging transaction includes a transaction entered into primarily to manage such other risks as the Secretary may prescribe in regulations.

California Law

Current state law conforms with federal law as it relates to taxation of income and losses on derivatives prior to the passage the Ticket to Work and Work Incentives Improvement Act of 1999. However, California's capital gain tax rate is the same as ordinary income tax rate.

This bill would conform state law to the changes made to federal law with respect to taxation of income and losses on derivatives effective for any instrument held, acquired, or entered into, any transaction entered into, and supplies held or acquired on or after January 1, 2002.

15. Expand Reporting of Cancellation of Indebtedness Income

Under federal and state laws, a taxpayer's gross income includes income from the discharge of indebtedness.

Federal law requires “applicable entities” to file information returns with the Internal Revenue Service (IRS) regarding any discharge of indebtedness of $600 or more. The information return must set forth the name, address, and taxpayer identification number of the person whose debt was discharged, the amount of debt discharged, the date on which the debt was discharged, and any other information that the IRS requires to be provided.

The information return must be filed in the manner and at the time specified by the IRS. The same information also must be provided to the person whose debt is discharged by January 31 of the year following the discharge.

“Applicable entities” include: (1) the Federal Deposit Insurance Corporation (FDIC), the Resolution Trust Corporation (RTC), the National Credit Union Administration, and successor or subunit of any of them; (2) any financial institution (as described in IRC Sec. 581 (relating to banks) or IRC Sec. 591(a) (relating to savings institutions)); (3) any credit union; (4) any corporation that is a direct or indirect subsidiary of an entity described in (2) or (3) which, by virtue of being affiliated with such entity, is subject to supervision and examination by a federal or state agency regulating such entities; and (5) an executive, judicial, or legislative agency (as defined in 31 U.S.C. Section 3701(a)(4)).

Failures to file correct information returns with the IRS or to furnish statements to taxpayers with respect to these discharges of indebtedness are subject to the same general penalty that is imposed with respect to failures to provide other types of information returns. Accordingly, the penalty for failure to furnish statements to taxpayers is generally $50 per failure, subject to a maximum of $100,000 for any calendar year. These penalties are not applicable if the failure is due to reasonable cause and not to willful neglect.

The Ticket to Work and Work Incentives Improvement Act of 1999 requires information reporting on indebtedness discharged by any organization for which a significant trade or business is the lending of money (such as finance companies and credit card companies regardless of whether affiliated with financial institutions).

California Law

Current state law conforms to the federal information reporting requirements for cancellation of indebtedness income prior to the passage of the Act by allowing the department to request a copy of the information return filed with the IRS.

This bill would conform to the expansion of the entities from which a copy of the information return filed with the IRS could be obtained by the department.

16. Limit Conversion of Character of Income from Constructive Ownership Transactions

Under federal law, the maximum individual income tax rate on ordinary income and short-term capital gain is 39.6%, while the maximum individual income tax rate on long-term capital gain generally is 20%. Although state law conforms to the definitions, rules, and holding periods for ordinary income, short-term capital gain, and long-term capital gain, there is no difference in the tax rate applicable to these categories of income.

Under federal and state laws, long-term capital gain means gain from the sale or exchange of a capital asset held more than one year. For this purpose, gain from the termination of a right with respect to property which would be a capital asset in the hands of the taxpayer is treated as capital gain.

A pass-through entity (such as a partnership) generally is not subject to federal or state income tax. Rather, each owner includes its share of a pass-through entity's income, gain, loss, deduction or credit in its taxable income. Generally, the character of the item is determined at the entity level and flows through to the owners. Thus, for example, the treatment of an item of income by a partnership as ordinary income, short-term capital gain, or long-term capital gain retains its character when reported by each of the partners.

Investors may enter into forward contracts, notional principal contracts, and other similar arrangements with respect to property that provides the investor with the same or similar economic benefits as owning the property directly but with potentially different tax consequences (to the character and timing of any gain).

The Ticket to Work and Work Incentives Improvement Act of 1999 limited the amount of long-term capital gain a taxpayer could recognize from certain derivative contracts ("constructive ownership transactions") with respect to certain financial assets.

The amount of long-term capital gain is limited to the amount of such gain the taxpayer would have recognized if the taxpayer held the financial asset directly during the term of the derivative contract. Any gain in excess of this amount is treated as ordinary income. An interest charge is imposed on the amount of gain that is treated as ordinary income. The provision does not alter the tax treatment of the long-term capital gain that is not treated as ordinary income.

A taxpayer is treated as having entered into a constructive ownership transaction if the taxpayer (1) holds a long position under a notional principal contract with respect to the financial asset, (2) enters into a forward contract to acquire the financial asset, (3) is the holder of a call option, and the grantor of a put option, with respect to a financial asset, and the options have substantially equal strike prices and substantially contemporaneous maturity dates, or (4) to the extent provided in regulations, enters into one or more transactions, or acquires one or more other positions, that have substantially the same effect as any of the transactions described. Treasury regulations, when issued, are expected to provide specific standards for determining when other types of financial transactions, like those specified in the provision, have substantially the same effect of replicating the economic benefits of direct ownership of a financial asset without a significant change in the risk-reward profile with respect to the underlying transaction. It is not expected that leverage in a constructive ownership transaction would change the risk-reward profile with respect to the underlying transaction.

A “financial asset” is defined as (1) any equity interest in a pass-through entity, and (2) to the extent provided in regulations, any debt instrument and any stock in a corporation that is not a pass-through entity. A “pass-through entity” refers to:

(1) a regulated investment company (RIC),
(2) a real estate investment trust (REIT),
(3) a real estate mortgage investment conduit (REMIC),
(4) an S corporation,
(5) a partnership,
(6) a trust,
(7) a common trust fund,
(8) a passive foreign investment company (PFC) which includes an investment company that is also a controlled foreign corporation,
(9) a foreign personal holding company, and
(10) a foreign investment company.

The amount of recharacterized gain is calculated as the excess of the amount of long-term capital gain the taxpayer would have had absent this provision over the “net underlying long-term capital gain” attributable to the financial asset.

The net underlying long-term capital gain is the amount of net capital gain the taxpayer would have realized if it had acquired the financial asset for its fair market value on the date the constructive ownership transaction was opened and sold the financial asset on the date the transaction was closed (only taking into account gains and losses that would have resulted from a deemed ownership of the financial asset). A taxpayer must establish the amount of the net underlying long-term capital gain with clear and convincing evidence; otherwise, the amount is deemed to be zero.

To the extent that the economic positions of the taxpayer and the counter party do not equally offset each other, the amount of the net underlying long-term capital gain may be difficult to establish. The long-term capital gains rate on the net underlying long-term capital gain is determined by reference to the individual capital gains rates.

> Example 1: On January 1, 2000, Taxpayer enters into a three-year notional principal contract (a constructive ownership transaction) with a securities dealer whereby, on the settlement date, the dealer agrees to pay Taxpayer the amount of any increase in the notional value of an interest in an investment partnership (the financial asset). After three years, the value of the notional principal contract increased by $200,000, of which $150,000 is attributable to ordinary income and net short-term capital gain ($50,000 is attributable to net long-term capital gains). The amount of the net underlying long-term capital gains is $50,000, and the amount of gain that is recharacterized as ordinary income is $150,000 (the excess of $200,000 of long-term gain over the $50,000 of net underlying long-term capital gain).

An interest charge is imposed on the underpayment of tax for each year that the constructive ownership transaction was open. The interest charge is the amount of interest that would be imposed had the recharacterized gain been included in the taxpayer's gross income during the term of the constructive ownership transaction.

The recharacterized gain is treated as having accrued such that the gain in each successive year is equal to the gain in the prior year increased by a constant growth rate during the term of the constructive ownership transaction.

> Example 2: Same facts as in example 1, and assume the applicable federal rate on December 31, 2002, is 6%. For purposes of calculating the interest charge, Taxpayer must allocate the $150,000 of recharacterized ordinary income to the three year-term of the constructive ownership transaction as follows: $47,116.47 is allocated to year 2000, $49,943.46 is allocated to year 2001, and $52,940.07 is allocated to year 2002.

A taxpayer is treated as holding a long position under a notional principal contract with respect to a financial asset if the person (1) has the right to be paid (or receive credit for) all or substantially all of the investment yield (including appreciation) on the financial asset for a specified period, and (2) is obligated to reimburse (or provide credit) for all or substantially all of any decline in the value of the financial asset. A forward contract is a contract to acquire in the future (or provide or receive credit for the future value of) any financial asset.

If the constructive ownership transaction is closed by reason of taking delivery of the underlying financial asset, the taxpayer is treated as having sold the contract, option, or other position that is part of the transaction for its fair market value on the closing date. However, the amount of gain that is recognized as a result of having taken delivery is limited to the amount of gain that is treated as ordinary income by reason of this provision (with appropriate basis adjustments for such gain). The provision does not apply to any constructive ownership transaction if all of the positions that are part of the transaction are marked to market under the IRC or regulations. The Treasury Department is authorized to prescribe regulations as necessary to carry out the purposes of the provision, including to (1) permit taxpayers to mark to market constructive ownership transactions in lieu of the provision, and (2) exclude certain forward contracts that do not convey substantially all of the economic return with respect to a financial asset.

For federal purposes the provision applies to transactions entered into on or after July 12, 1999. For this purpose, it is expected that a contract, option or any other arrangement that is entered into or exercised on or after July 12, 1999, which extends or otherwise modifies the terms of a transaction entered into prior to such date will be treated as a transaction entered into on or after July 12, 1999, unless a party to the transaction other than the taxpayer has, as of July 12, 1999, the exclusive right to extend the terms of the transaction, and the length of such extension does not exceed the first business day following a period of five years from the original termination date under the transaction. No inference is intended as to the proper treatment of a constructive ownership transaction entered into prior to the effective date of this provision.

<u>California Law</u>

Current state law is generally in conformity with federal law as it relates to the computation of capital gain verses ordinary income. California, however, does not have different tax rates for capital gain and ordinary income.

This bill conforms to the new federal rules regarding constructive ownership transactions entered into on or after January 1, 2002.

17. Treatment of Excess Pension Assets Used for Retiree Health B

Under federal and state laws, defined benefit pension plan assets generally may not revert to an employer prior to the termination of the plan and the satisfaction of all plan liabilities. A reversion prior to plan termination may constitute a prohibited transaction and may result in disqualification of the plan. Certain limitations and procedural requirements apply to a reversion upon plan termination. Under federal and state laws, any assets that revert to the employer upon plan termination are includible in the gross income of the employer.

Under federal law, such assets are subject to an excise tax. Under federal and state law upon plan termination, the accrued benefits of all plan participants are required to be 100% vested.

Under federal and state laws, a pension plan may provide medical benefits to retired employees through an IRC Sec. 401(h) account that is a part of such plan. A qualified transfer of excess assets of a defined benefit pension plan (other than a multi-employer plan) into an IRC Sec. 401(h) account that is a part of such plan does not result in plan disqualification and is not treated as a reversion to the employer or a prohibited transaction. Therefore, the transferred assets are not includible in the gross income of the employer and are not subject to the excise tax on reversions.

Qualified transfers are subject to amount and frequency limitations, use requirements, deduction limitations, vesting requirements, and minimum benefit requirements.

Excess assets transferred in a qualified transfer may not exceed the amount reasonably estimated to be the amount that the employer will pay out of such account during the taxable year of the transfer for qualified current retiree health liabilities. No more than one qualified transfer with respect to any plan may occur in any taxable year.

The transferred assets (and any income thereon) must be used to pay qualified current retiree health liabilities (either directly or through reimbursement) for the taxable year of the transfer. Transferred amounts generally must benefit all pension plan participants, other than key employees, who are entitled upon retirement to receive retiree medical benefits through the IRC Sec. 401(h) account. Retiree health benefits of key employees may not be paid (directly or indirectly) out of transferred assets. Amounts not used to pay qualified current retiree health liabilities for the taxable year of the transfer are to be returned at the end of the taxable year to the general assets of the plan. These amounts are not includible in the gross income of the employer, but are treated as an employer reversion and are subject to a 20% federal excise tax.

No deduction is allowed for (1) a qualified transfer of excess pension assets into an IRC Sec. 401(h) account, (2) the payment of qualified current retiree health liabilities out of transferred assets (and any income thereon) or (3) a return of amounts not used to pay qualified current retiree health liabilities to the general assets of the pension plan.

In order for the transfer to be qualified, accrued retirement benefits under the pension plan generally must be 100% vested as if the plan terminated immediately before the transfer.

The minimum benefit requirement requires each group health plan under which applicable health benefits are provided to provide substantially the same level of applicable health benefits for the taxable year of the transfer and the following four taxable years. The level of benefits that must be maintained is based on benefits provided in the year immediately preceding the taxable year of the transfer. Applicable health benefits are health benefits or coverage that are provided to (1) retirees who, immediately before the transfer, are entitled to receive such benefits upon retirement and who are entitled to pension benefits under the plan and (2) the spouses and dependents of such retirees.

The provision permitting a qualified transfer of excess pension assets to pay qualified current retiree health liabilities expires for taxable years beginning after December 31, 2000.

The Ticket to Work and Work Incentives Improvement Act of 1999 extends the present-law provision permitting qualified transfers of excess defined benefit pension plan assets to provide retiree health benefits under an IRC Sec. 401(h) account through December 31, 2005.

In addition, the present law minimum benefit requirement is replaced by the minimum cost requirement that applied to qualified transfers before December 9, 1994, to IRC Sec. 401(h) accounts.

Therefore, each group health plan or arrangement under which applicable health benefits are provided is required to provide a minimum dollar level of retiree health expenditures for the taxable year of the transfer and the following four taxable years. The minimum dollar level is the higher of the applicable employer costs for each of the two taxable years immediately preceding the taxable year of the transfer. The applicable employer cost for a taxable year is determined by dividing the employer's qualified current retiree health liabilities by the number of individuals to whom coverage for applicable health benefits was provided during the taxable year.

The Secretary of the Treasury is directed to prescribe such regulations as may be necessary to prevent an employer who significantly reduces retiree health coverage during the cost maintenance period from being treated as satisfying the minimum cost requirement. In addition, the provision contains a transition rule regarding the minimum cost requirement.

California Law

Current state law conforms to the federal law provisions relating to qualified transfers of excess defined benefit pension plans as it read on January 1, 1998. However, California does not impose the excise tax on assets that revert to the employer upon termination of the plan.

This bill would conform to the provision permitting qualified transfers of excess defined benefit pension plan assets to provide retiree health benefits under an IRC Sec. 401(h) account through December 31, 2005. In addition, this bill would conform to the provision replacing the present law minimum benefit requirement with the new federal minimum cost requirement.

18. Modification of the Installment Method Pledge Rules

An accrual method taxpayer is generally required to recognize income when all the events have occurred that fix the right to the receipt of the income and the amount of the income can be determined with reasonable accuracy. The installment method of accounting provides an exception to this general principle of income recognition by allowing a taxpayer to defer the recognition of income from the disposition of certain property until payment is received. Sales to customers in the ordinary course of business are not eligible for the installment method, except for sales of property that is used or produced in the trade or business of farming and sales of timeshares and residential lots if an election to pay interest under section 453(l)(2)(B) is made.

A pledge rule provides that if an installment obligation is pledged as security for any indebtedness, the net proceeds of such indebtedness are treated as a payment on the obligation, triggering the recognition of income. Actual payments received on the installment obligation subsequent to the receipt of the loan proceeds are not taken into account until such subsequent payments exceed the loan proceeds that were treated as payments. The pledge rule does not apply to sales of property used or produced in the trade or business of farming, to sales of timeshares and residential lots where the taxpayer elects to pay interest under section 453(l)(2)(B), or to dispositions where the sales price does not exceed $150,000.

An additional rule requires the payment of interest on the deferred tax that is attributable to most large installment sales.

The Ticket to Work Act modifies the pledge rule to provide that entering into any arrangement that gives the taxpayer the right to satisfy an obligation with an installment note will be treated in the same manner as the direct pledge of the installment note. For example, a taxpayer disposes of property for an installment note. The disposition is properly reported using the installment method. The taxpayer only recognizes gain as it receives the deferred payment.

However, were the taxpayer to pledge the installment note as security for a loan, it would be required to treat the proceeds of such loan as a payment on the installment note and recognize the appropriate amount of gain. Under the provision, the taxpayer would also be required to treat the proceeds of a loan as payment on the installment note to the extent the taxpayer had the right to “put” or repay the loan by transferring the installment note to the taxpayer's creditor. Other arrangements that have a similar effect would be treated in the same manner.

The modification of the pledge rule applies only to installment sales where the pledge rule of present law applies. Accordingly, the provision does not apply to (1) installment method sales made by a dealer in timeshares and residential lots where the taxpayer elects to pay interest under section 453(l)(2)(B), (2) sales of property used or produced in the trade or business of farming, or (3) dispositions where the sales price does not exceed $150,000, since such sales are not subject to the pledge rule under present law.

The Installment Tax Correction Act of 2000 [which hasn't been mentioned previously] repealed the prohibition on the use of the installment method of accounting for dispositions of property that would otherwise be required to be reported using the accrual method of accounting. That Act left unchanged the 1999 modification to the pledge rule for federal purposes.

California Law

California is in conformity with federal law prior to the passage of the Ticket to Work Act and the Installment Tax Correction Act as it relates to installment sales.

This bill would conform to the changes made to the pledge rules the Ticket to Work Act.

19. Denial of Charitable Contrib. Deduct. for Transfers Assoc. w/ Split-Dollar Insurance Arra

Under current federal and state laws, in computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct charitable contributions paid during the taxable year. The amount of the deduction allowable for a taxable year with respect to any charitable contribution depends on the type of property contributed, the type of organization to which the property is contributed, and the income of the taxpayer. A charitable contribution is defined to mean a contribution or gift to or for the use of a charitable organization or certain other entities. The term "contribution or gift" is not defined by statute, but generally is interpreted to mean a voluntary transfer of money or other property without receipt of adequate consideration and with donative intent.

If a taxpayer receives or expects to receive a "quid pro quo" in exchange for a transfer to charity, the taxpayer may be able to deduct the excess of the amount transferred over the fair market value of any benefit received in return, provided the excess payment is made with the intention of making a gift.

In general, no charitable contribution deduction is allowed for a transfer to charity of less than the taxpayer's entire interest (i.e., a partial interest) in any property. In addition, no deduction is allowed for any contribution of $250 or more unless the taxpayer obtains a contemporaneous written acknowledgment from the donee organization that includes a description and good faith estimate of the value of any goods or services provided by the donee organization to the taxpayer in consideration, in whole or in part, for the taxpayer's contribution (i.e., the "quid pro quo").

Deduction Denial

The Ticket to Work and Work Incentives Improvement Act Of 1999 restates present law to provide that no charitable contribution deduction is allowed for purposes of federal tax, for a transfer to or for the use of an organization described in IRC Sec. 170(c), if in connection with the transfer (1) the organization directly or indirectly pays, or has previously paid, any premium on any "personal benefit contract" with respect to the transferor, or (2) there is an understanding or expectation that any person will directly or indirectly pay any premium on any "personal benefit contract" with respect to the transferor. It is intended that an organization be considered as indirectly paying premiums if, for example, another person pays premiums on its behalf.

A personal benefit contract with respect to the transferor is any life insurance, annuity, or endowment contract, if any direct or indirect beneficiary under the contract is the transferor, any member of the transferor's family, or any other person (other than an IRC Sec. 170(c) organization) designated by the transferor.

For example, such a beneficiary would include a trust having a direct or indirect beneficiary who is the transferor or any member of the transferor's family, and would include an entity that is controlled by the transferor or any member of the transferor's family. It is intended that a beneficiary under the contract include any beneficiary under any side agreement relating to the contract. If a transferor contributes a life insurance contract to an I.R.C. Section 170(c) organization and designates one or more IRC Sec. 170(c) organizations as the sole beneficiaries under the contract, generally, it is not intended that the deduction denial rule under the provision apply. If, however, there is an outstanding loan under the contract upon the transfer of the contract, then the transferor is considered as a beneficiary. The fact that a contract also has other direct or indirect beneficiaries (persons who are not the transferor or a family member, or designated by the transferor) does not prevent it from being a personal benefit contract. The provision is not intended to affect situations in which an organization pays premiums under a legitimate fringe benefit plan for employees.

It is intended that a person be considered as an indirect beneficiary under a contract if, for example, the person receives or will receive any economic benefit as a result of amounts paid under or with respect to the contract. For this purpose, as described below, an indirect beneficiary is not intended to include a person that benefits exclusively under a bona fide charitable gift annuity (within the meaning of IRC Sec. 501(m)).

In the case of a charitable gift annuity, if the charitable organization purchases an annuity contract issued by an insurance company to fund its obligation to pay the charitable gift annuity, a person receiving payments under the charitable gift annuity is not treated as an indirect beneficiary, provided certain requirements are met. The requirements are that (1) the charitable organization possess all of the incidents of ownership (within the meaning of Treas. Reg. Section 20.2042 1(c)) under the annuity contract purchased by the charitable organization; (2) the charitable organization be entitled to all the payments under the contract; and (3) the timing and amount of payments under the contract be substantially the same as the timing and amount of payments to each person under the organization's obligation under the charitable gift annuity (as in effect at the time of the transfer to the charitable organization).

Under the provision, an individual's family consists of the individual's grandparents, the grandparents of the individual's spouse, the lineal descendants of such grandparents, and any spouse of such a lineal descendant.

In the case of a charitable gift annuity obligation that is issued under the laws of a state that requires, in order for the charitable gift annuity to be exempt from insurance regulation by that state, that each beneficiary under the charitable gift annuity be named as a beneficiary under an annuity contract issued by an insurance company authorized to transact business in that state, then the foregoing requirements (1) and (2) are treated as if they are met, provided that certain additional requirements are met.

The additional requirements are that the state law requirement was in effect on February 8, 1999, each beneficiary under the charitable gift annuity is a bona fide resident of the state at the time the charitable gift annuity was issued, the only persons entitled to payments under the annuity contract issued by the insurance company are persons entitled to payments under the charitable gift annuity when it was issued, and the timing and amount of payments under the annuity contract to each person are substantially the same as the timing and amount of payments to the person under the charitable gift annuity (as in effect at the time of the transfer to the charitable organization).

In the case of a charitable remainder annuity trust or charitable remainder unitrust that holds a life insurance, endowment or annuity contract issued by an insurance company, a person is not treated as an indirect beneficiary under the contract held by the trust, solely by reason of being a recipient of an annuity or unitrust amount paid by the trust, provided that the trust possesses all of the incidents of ownership under the contract and is entitled to all the payments under such contract. No inference is intended as to the applicability of other provisions of the IRC with respect to the acquisition by the trust of a life insurance, endowment or annuity contract, or the appropriateness of such an investment by a charitable remainder trust.

Nothing in the provision is intended to suggest that a life insurance, endowment, or annuity contract would be a personal benefit contract, solely because an individual who is a recipient of an annuity or unitrust amount paid by a charitable remainder annuity trust or charitable remainder unitrust uses such a payment to purchase a life insurance, endowment or annuity contract, and a beneficiary under the contract is the recipient, a member of his or her family, or another person he or she designates.

The federal deduction denial provision applies to transfers after February 8, 1999.

California Law

Current state law conforms to the federal law as it relates to charitable contribution deduction of split-dollar insurance prior to the passage the Ticket to Work and Work Incentives Improvement Act of 1999.

This bill conforms to the deduction denial provision with respect to transfers on or after January 1, 2002.

20. Distributions by a Partnership to a Corporate Partner of Stock in Another Corp

Current federal and state laws generally provide that no gain or loss is recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation in which it holds 80% of the stock (by vote and value) (IRC Sec. 332). The basis of property received by a corporate distributee in the distribution in complete liquidation of the 80% owned subsidiary is a carryover basis, i.e., the same as the basis in the hands of the subsidiary (provided no gain or loss is recognized by the liquidating corporation with respect to the distributed property) (IRC Sec. 334(b)).

Current federal and state laws provide two different rules for determining a partner's basis in distributed property, depending on whether or not the distribution is in liquidation of the partner's interest in the partnership.

Generally, a substituted basis rule applies to property distributed to a partner in liquidation. Thus, the basis of property distributed in liquidation of a partner's interest is equal to the partner's adjusted basis in its partnership interest (reduced by any money distributed in the same transaction) (IRC Sec. 732(b)).

By contrast, generally, a carryover basis rule applies to property distributed to a partner other than in liquidation of its partnership interest, subject to a cap (IRC Sec. 732(a)). Thus, in a non-liquidating distribution, the distributee partner's basis in the property is equal to the partnership's adjusted basis in the property immediately before the distribution, but not to exceed the partner's adjusted basis in its partnership interest (reduced by any money distributed in the same transaction). In a non-liquidating distribution, the partner's basis in its partnership interest is reduced by the amount of the basis to the distributee partner of the property distributed and is reduced by the amount of any money distributed (IRC Sec. 733).

If corporate stock is distributed by a partnership to a corporate partner with a low basis in its partnership interest, the basis of the stock is reduced in the hands of the partner so that the stock basis equals the distributee partner's adjusted basis in its partnership interest. No comparable reduction is made in the basis of the corporation's assets, however. The effect of reducing the stock basis can be negated by a subsequent liquidation of the corporation under IRC Sec. 332.

In General

The Ticket to Work and Work Incentives Improvement Act of 1999 provides for a basis reduction to assets of a corporation, if stock in that corporation is distributed by a partnership to a corporate partner. The reduction applies if, after the distribution, the corporate partner controls the distributed corporation.

1. Amount of the Basis Reduction

Under this provision, the amount of the reduction in basis of property of the distributed corporation generally equals the amount of the excess of (1) the partnership's adjusted basis in the stock of the distributed corporation immediately before the distribution, over (2) the corporate partner's basis in that stock immediately after the distribution.

The provision limits the amount of the basis reduction in two respects. First, the amount of the basis reduction may not exceed the amount by which (1) the sum of the aggregate adjusted bases of the property and the amount of money of the distributed corporation exceeds (2) the corporate partner's adjusted basis in the stock of the distributed corporation.

For example, if the distributed corporation has cash of $300 and other property with a basis of $600 and the corporate partner's basis in the stock of the distributed corporation is $400, then the amount of the basis reduction could not exceed $500 (i.e., ($300+$600)-$400 = $500).

Second, the amount of the basis reduction may not exceed the adjusted basis of the property of the distributed corporation. Thus, the basis of property (other than money) of the distributed corporation could not be reduced below zero under the provision, even though the total amount of the basis reduction would otherwise be greater.

This provision provides that the corporate partner recognizes long-term capital gain to the extent the amount of the basis reduction exceeds the basis of the property (other than money) of the distributed corporation. In addition, the corporate partner's adjusted basis in the stock of the distribution is increased in the same amount.

> For example, if the amount of the basis reduction were $400, and the distributed corporation has money of $200 and other property with an adjusted basis of $300, then the corporate partner would recognize a $100 capital gain under the provision. The corporate partner's basis in the stock of the distributed corporation is also increased by $100 in this example, under the provision.

The basis reduction is allocated among assets of the controlled corporation in accordance with the rules provided under IRC Sec. 732(c).

2. Partnership Distributions Resulting in Control

The basis reduction generally applies with respect to a partnership distribution of stock if the corporate partner controls the distributed corporation immediately after the distribution or at any time thereafter. For this purpose, the term control means ownership of stock meeting the requirements of IRC Sec. 1504(a)(2) (generally, an 80% vote and value requirement).

This provision applies to reduce the basis of any property held by the distributed corporation immediately after the distribution, or, if the corporate partner does not control the distributed corporation at that time, then at the time the corporate partner first has such control. The provision does not apply to any distribution if the corporate partner does not have control of the distributed corporation immediately after the distribution and establishes that the distribution was not part of a plan or arrangement to acquire control.

For purposes of the provision, if a corporation acquires (other than in a distribution from a partnership) stock the basis of which is determined (by reason of being distributed from a partnership) in whole or in part by reference to IRC Sec. 732(a)(2) or (b), then the corporation is treated as receiving a distribution of stock from a partnership.

> For example, if a partnership distributes property other than stock (such as real estate) to a corporate partner, and that corporate partner contributes the real estate to another corporation in an IRC Sec. 351 transaction, then the stock received in the IRC Sec. 351 transaction is not treated as distributed by a partnership, and the basis reduction under this provision does not apply.

As another example, if a partnership distributes stock to two corporate partners, neither of which have control of the distributed corporation, and the two corporate partners merge and the survivor obtains control of the distributed corporation, the stock of the distributed corporation that is acquired as a result of the merger is treated as received in a partnership distribution; the basis reduction rule of the provision applies.

In the case of tiered corporations, a special rule provides that if the property held by a distributed corporation is stock in a corporation that the distributed corporation controls, then the provision is applied to reduce the basis of the property of that controlled corporation. The provision is also reapplied to any property of any controlled corporation that is stock in a corporation that it controls. Thus, for example, if stock of a controlled corporation is distributed to a corporate partner, and the controlled corporation has a subsidiary, the amount of the basis reduction allocable to stock of the subsidiary is applied again to reduce the basis of the assets of the subsidiary, under the special rule.

This provision also provides for regulations, including regulations to avoid double counting and to prevent the abuse of the purposes of the provision. It is intended that regulations prevent the avoidance of the purposes of the provision through the use of tiered partnerships.

This provision is effective generally for distributions made after July 14, 1999. However, in the case of a corporation that is a partner in a partnership as of July 14, 1999, the provision is effective for any distribution made (or treated as made) to that partner from that partnership after June 30, 2001.

In the case of any such distribution after the date of enactment and before July 1, 2001, the rule of the preceding sentence does not apply unless that partner makes an election to have the rule apply to the distribution on the partner's return of federal income tax for the taxable year in which the distribution occurs.

No inference is intended that distributions that are not subject to the provision achieve a particular tax result under present law, and no inference is intended that enactment of the provision limits the application of tax rules or principles under present or prior law.

California Law

Current state law conforms to the federal law as it relates to partnership distributions of corporate stock prior to the passage of the Ticket to Work and Work Incentives Improvement Act of 1999.

This bill would conform to the new federal rules for transactions after January 1, 2002, and make the federal treatment elected by the taxpayer binding for state purposes.

21 Increase the Low-Income Housing Tax Credit Cap and Make Other Modifications

The low-income housing tax credit may be claimed over a 10-year period for the cost of rental housing occupied by tenants having incomes below specified levels. The credit percentage for newly constructed or substantially rehabilitated housing that is not federally-subsidized is adjusted monthly by the Internal Revenue Service so that the 10 annual installments have a present value of 70% of the total qualified expenditures. The credit percentage for new substantially rehabilitated housing that is federally-subsidized and for existing housing that is substantially rehabilitated is calculated to have a present value of 30% qualified expenditures.

Credit Cap

The aggregate credit authority provided annually to each state is $1.25 per resident, except in the case of projects that also receive financing with proceeds of tax-exempt bonds issued subject to the private activity bond volume limit and certain carry-over amounts.

Expenditure Test

Generally, the building must be placed in service in the year in which it receives an allocation to qualify for the credit. An exception is provided in the case where the taxpayer has expended an amount equal to 10 percent or more of the taxpayer's reasonably expected basis in the building by the end of the calendar year in which the allocation is received and certain other requirements are met.

Basis of Building Eligible for the Credit

Buildings receiving assistance under the HOME investment partnerships act ("HOME") are not eligible for the enhanced credit for buildings located in high cost areas (i.e., qualified census tracts and difficult development areas). Under the enhanced credit, the 70 percent and 30 percent credit are increased to a 91 percent and 39 percent credit, respectively.

Eligible basis is generally limited to the portion of the building used by qualified low-income tenants for residential living and some common areas.

State Allocation Plans

Each state must develop a plan for allocating credits and such plan must include certain allocation criteria including:

(1) project location;
(2) housing needs characteristics;
(3) project characteristics;
(4) sponsor characteristics;
(5) participation of local tax-exempts;
(6) tenant populations with special needs; and
(7) public housing waiting lists.

The state allocation plan must also give preference to housing projects (1) that serve the lowest income tenants, and (2) that are obligated to serve qualified tenants for the longest periods.

Credit Administration

There are no explicit requirements that housing credit agencies perform a comprehensive market study of the housing needs of the low-income individuals in the area to be served by the project, nor that such agency conduct site visits to monitor for compliance with habitability standards.

Stacking Rule

Authority to allocate credits remains at the state (as opposed to local) government level, unless state law provides otherwise. Generally, credits may be allocated only from volume authority arising during the calendar year in which the building is placed in service, except in the case of:

(1) credits claimed on additions to qualified basis;
(2) credits allocated in a later year pursuant to an earlier binding commitment made no later than the year in which the building is placed in service; and
(3) carryover allocations.

Each state annually receives low-income housing credit authority equal to $1.25 per state resident for allocation to qualified low-income projects. In addition to this $1.25 per resident amount, each state's "housing credit ceiling" includes the following amounts:

(1) the unused state housing credit ceiling (if any) of such state for the preceding calendar year;
(2) the amount of the state housing credit ceiling (if any) returned in the calendar year; and
(3) the amount of the national pool (if any) allocated to such state by the Treasury Department.

The national pool consists of states' unused housing credit carryovers. For each state, the unused housing credit carryover for a calendar year consists of the excess (if any) of the unused state housing credit ceiling for such year over the excess (if any) of the aggregate housing credit dollar amount allocated for such year over the sum of $1.25 per resident and the credit returns for such year. The amounts in the national pool are allocated only to a state that allocated its entire housing credit ceiling for the preceding calendar year, and requested a share in the national pool not later than May 1 of the calendar year. The national pool allocation to qualified states is made on a pro rata basis equivalent to the fraction that a state's population enjoys relative to the total population of all qualified states for that year.

The stacking rule provides that a state is treated as using its annual allocation of credit authority ($1.25 per state resident) and any returns during the calendar year followed by any unused credits carried forward from the preceding year's credit ceiling and finally any applicable allocations from the national pool.

The Appropriations Act, 2001, makes the following changes in the low-income housing credit:

Credit cap -- Increases the per-capita low-income housing credit cap from $1.25 per capita to $1.50 per capita in calendar year 2001 and to $1.75 per capita in calendar year 2002. Beginning in calendar year 2003, the per-capita portion of the credit cap will be adjusted annually for inflation. For small states, a minimum annual cap of $2 million is provided for calendar years 2001 and 2002. Beginning in calendar year 2003, the small state minimum is adjusted for inflation.

Expenditure test -- Allows a building which receives an allocation in the second half of a calendar year to qualify under the 10 percent test if the taxpayer expends an amount equal to 10 percent or more of the taxpayer's reasonably expected basis in the building within six months of receiving the allocation, regardless of whether the 10 percent test is met by the end of the calendar year.

Basis of building eligible for the credit – The Appropriations Act, 2001 makes three changes to the basis rules of the credit. First, the definition of qualified census tracts for purposes of the enhanced credit is expanded to include any census tracts with a poverty rate of 25% or more. Second, the Appropriations Act, 2001 extends the credit to a portion of the building used as a community service facility not in excess of 10% of the total eligible basis in the building. A community service facility is defined as any facility designed to serve primarily individuals whose income is 60% or less of area median income. Third, the Appropriations Act, 2001 provides that assistance received under the Native American Housing Assistance and Self-Determination Act of 1996 is not taken into account in determining whether a building is federally subsidized for purposes of the credit. This allows such buildings to qualify for something other than the 30 percent credit generally applicable to federally subsidized buildings.

State allocation plans -- Strikes the plan criteria relating to participation of local tax-exempts, replacing it with two other criteria: (1) tenant populations of individuals with children, and (2) projects intended for eventual tenant ownership. It also provides that the present-law criteria relating to sponsor characteristics include whether the project involves the use of existing housing as part of a community revitalization plan. The Appropriations Act, 2001 adds a third category of housing projects to the preferential list, for projects located in qualified census tracts that contribute to a concerted community revitalization plan.

Credit administration --Requires a comprehensive market study of the housing needs of the low-income individuals in the area to be served by the project and a written explanation available to the general public for any allocation not made in accordance with the established priorities and selection criteria of the housing credit agency. They also require site inspections by the housing credit agency to monitor compliance with habitability standards applicable to the project.

Stacking rule -- Modifies the stacking rule so that each state is treated as using its allocation of the unused state housing credit ceiling (if any) from the preceding calendar before the current year's allocation of credit (including any credits returned to the state) and then finally any national pool allocations.

California Law (Secs. 17058 and 23610.5)

California is in conformity with federal law as it read on January 1, 1998, except that the state credit amount is 30% of the costs, is claimed over a four-year period, and is limited to projects located in California. The Tax Credit Allocation Committee is authorized to allocate up to a maximum of $50 million per year (effective for years beginning after 1999). The Committee provides listings of qualified taxpayers to the Franchise Tax Board. This credit may reduce the regular tax below the "tentative minimum tax." If the credit exceeds the tax, the excess may be carried over.

This bill would conform to the Appropriations Act, 2001, changes effective for taxable years beginning on or after January 1, 2002.

22. Extension & Modification of Enhanced Deduct. for Corporate Donations of Computer Technology

Under federal and state laws, the maximum charitable contribution deduction that may be claimed by a corporation for any one taxable year is limited to 10% of the corporation's taxable income for that year (disregarding charitable contributions and with certain other modifications). (Sec. 170(b)(2).) Corporations also are subject to certain limitations based on the type of property contributed. In the case of a charitable contribution of short-term gain property, inventory, or other ordinary income property, the amount of the deduction generally is limited to the taxpayer's basis (generally, cost) in the property. However, special rules in the IRC provide an augmented deduction for certain corporate contributions. Under these special rules, the amount of the augmented deduction is equal to the lesser of (1) the basis of the donated property plus one-half of the amount of ordinary income that would have been realized if the property had been sold, or (2) twice the basis of the donated property.

Section 170(e)(6) allows corporate taxpayers an augmented deduction for qualified contributions of computer technology and equipment (i.e., computer software, computer or peripheral equipment, and fiber optic cable related to computer use) to be used within the United States for educational purposes in grades K-12. Eligible donees are (1) any educational organization that normally maintains a regular faculty and curriculum and has a regularly enrolled body of pupils in attendance at the place where its educational activities are regularly carried on, and (2) tax exempt charitable organizations that are organized primarily for purposes of supporting elementary and secondary education. A private foundation also is an eligible donee, provided that, within 30 days after receipt of the contribution, the private foundation contributes the property to an eligible donee described above.

Qualified contributions are limited to gifts made no later than two years after the date the taxpayer acquired or substantially completed the construction of the donated property. In addition, the original use of the donated property must commence with the donor or the donee. Accordingly, qualified contributions generally are limited to property that is no more than two years old. Such donated property could be computer technology or equipment that is inventory or depreciable trade or business property in the hands of the donor.

Donee organizations are not permitted to transfer the donated property for money or services (e.g., a donee organization cannot sell the computers). However, a donee organization may transfer the donated property in furtherance of its exempt purposes and be reimbursed for shipping, installation, and transfer costs. For example, if a corporation contributes computers to a charity that subsequently distributes the computers to several elementary schools in a given area, the charity could be reimbursed by the elementary schools for shipping, transfer, and installation costs.

The special treatment applies only to donations made by C corporations; thus, S corporations, personal holding companies, and service organizations are not eligible donors.

As originally enacted the provision was not to apply to contributions made during taxable years beginning after December 31, 1999. The IRS Restructuring and Reform Act of 1998 (P.L. 105-206) extended the provision for one year by amending the provision to not apply to contributions made during taxable years beginning after December 31, 2000.

The Appropriations Act, 2001 extended the deduction for donations of computer technology and equipment through December 31, 2003, and expands the enhanced deduction to include donations to public libraries. The Appropriations Act, 2001, provides that qualified contributions include gifts made no later than three years after the date the taxpayer acquired or substantially completed the construction of the donated property. Contributions may be made by a person that has reacquired the property (i.e., if a computer manufacturer reacquires the computer from the original user and then contributes it). Such reacquired property must be contributed within three years of the date the original construction of the property was substantially completed. Congress anticipates that for purposes of computing the enhanced deduction for a reacquirer, the Secretary will provide guidance in determining the retail value of donated computers (or other computer technology) in situations in which the number of actual retail sales of used computers similar to those donated is small in relation to the number of such computers that are donated. In addition, the Appropriations Act, 2001 provides that the Secretary may prescribe by regulation standards to ensure that the donations meet minimum functionality and suitability standards for educational purposes.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to corporate contributions of computer technology (AB 2797, Stat. 1998, Ch. 322). Thus, the augmented deduction for corporate contributions of computer technology expired for taxable years beginning on or after January 1, 2000.

This bill would allow the augmented deduction for corporate contributions of computer technology in taxable years beginning on or after January 1, 2002, and contributions made through December 31, 2003.

23. Medical Savings Accounts ("MSAs")

Within limits, contributions to a medical savings account ("MSA") are deductible in determining adjusted gross income ("AGI") under federal or state laws if made by an eligible individual and are excludable from gross income and wages for employment tax purposes if made by the employer of an eligible individual. Earnings on amounts in an MSA are not currently taxable. Distributions from an MSA for medical expenses are not taxable. Distributions not used for medical expenses are taxable. In addition, distributions not used for medical expenses are subject to an additional 15 percent tax unless the distribution is made after age 65, death, or disability.

MSAs are available to self-employed individuals and to employees covered under an employer-sponsored high-deductible plan of a small employer. An employer is a small employer if it employed, on average, no more than 50 employees on business days during either the preceding or the second preceding year.

In order for an employee of a small employer to be eligible to make MSA contributions (or to have employer contributions made on his or her behalf), the employee must be covered under an employer-sponsored high deductible health plan (see the definition below) and must not be covered under any other health plan (other than a plan that provides certain permitted coverage).

Similarly, in order to be eligible to make contributions to an MSA, a self-employed individual must be covered under a high deductible health plan and no other health plan (other than a plan that provides certain permitted coverage). A self-employed individual is not an eligible individual (by reason of being self-employed) if the high deductible plan under which the individual is covered is established or maintained by an employer of the individual (or the individual's spouse).

The maximum annual contribution that can be made to an MSA for a year is 65% of the deductible under the high deductible plan in the case of individual coverage and 75% of the deductible in the case of family coverage.

A high deductible plan is a health plan with an annual deductible of at least $1,550 and no more than $2,350 in the case of individual coverage, and at least $3,100 and no more than $4,650 in the case of family coverage. In addition, the maximum out-of-pocket expenses with respect to allowed costs (including the deductible) must be no more than $3,100 in the case of individual coverage and no more than $5,700 in the case of family coverage. A plan does not fail to qualify as a high deductible plan merely because it does not have a deductible for preventive care as required by state law. A plan does not qualify as a high deductible health plan if substantially all of the coverage under the plan is for permitted coverage. In the case of a self-insured plan, the plan must in fact be insurance (e.g., there must be appropriate risk shifting) and not merely a reimbursement arrangement.

The number of taxpayers benefiting annually from an MSA contribution is limited to a threshold level (generally 750,000 taxpayers). If it is determined in a year that the threshold level has been exceeded (called a "cut-off" year) then, in general, for succeeding years during the four-year pilot period 1997-2000, only those individuals who (1) made an MSA contribution or had an employer MSA contribution for the year or a preceding year (i.e., are active MSA participants), or (2) are employed by a participating employer, are eligible for an MSA contribution. In determining whether the threshold for any year has been exceeded, MSAs of individuals who were not covered under a health insurance plan for the six-month period ending on the date on which coverage under a high deductible plan commences would not be taken into account. However, if the threshold level is exceeded in a year, previously uninsured individuals are subject to the same restriction on contributions in succeeding years as other individuals. That is, they would not be eligible for an MSA contribution for a year following a cut-off year unless they are an active MSA participant (i.e., had an MSA contribution for the year or a preceding year) or are employed by a participating employer. The number of MSAs established has not exceeded the threshold level.

After December 31, 2000, no new contributions may be made to MSAs except by or on behalf of individuals who previously had MSA contributions and employees who are employed by a participating employer. An employer is a participating employer if (1) the employer made any MSA contributions for any year to an MSA on behalf of employees, or (2) at least 20% of the employees covered under a high deductible plan made MSA contributions of at least $100 in the year 2000.

Self-employed individuals who made contributions to an MSA during the period 1997-2000 also may continue to make contributions after 2000.

The Appropriations Act, 2001, extends the MSA program through 2002. The same rules that apply to the limitation on MSAs for 1999 also apply to 2001 and 2002. Thus, for example, the threshold level in those years is a total of 750,000 taxpayers.

The Appropriations Act, 2001, also renamed MSAs to Archer MSAs. Finally, the Congress clarifies that, as under present law, the cap and reporting requirements do not apply for 2000.

California Law

California is in conformity with federal law as it relates to MSAs. Section 17215 specifically provides "that the amount allowed as a deduction shall be an amount equal to the amount allowed to that individual as a deduction under Section 220 of the IRC on the federal income tax return filed for the same taxable year by that individual." Therefore, the federal MSA extension already applies for California.

This bill would affirm California's conformity to the MSA extension provision contained in the Appropriations Act, 2001.

24. Clarifying the Allowance of Certain Tax Benefits with Respect to Kidnapped Children

The IRC generally requires that a taxpayer provide over one-half of the support for each individual claimed as that taxpayer's dependent. Similarly, the child credit, the surviving spouse filing status, and the head of household filing status require that a taxpayer satisfy certain requirements with regard to individuals that qualify as the taxpayer's dependent(s). Finally, the earned income credit for taxpayers with qualifying children generally is available only if the taxpayer has the same principal place of abode for more than one-half the taxable year with an otherwise qualifying child.

Recently published IRS guidance first denied a dependency exemption to certain taxpayers with kidnapped children (TAM 200034029), then later allowed these tax benefits to such taxpayers (TAM 200038059).

The Appropriations Act, 2001, clarifies that the dependency exemption, the child credit, the surviving spouse filing status, the head of household filing status, and the earned income credit are available to an otherwise qualifying taxpayer with respect to a child who is presumed by law enforcement authorities to have been kidnapped by someone who is not a member of the family of such child or the taxpayer. Generally, this treatment continues for all taxable years ending during the period that the child is treated as kidnapped. However, this treatment ends for the taxable year ending after the calendar year in which it is determined that the child is dead (or, if earlier, in which the child would have attained age 18).

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to the definition of dependents and head of household. Thus, a kidnapped child would be allowed to be treated as a dependent under the rationale of TAM 200038059. California law does not provide an earned income or young child credit. California law has not conformed to the changes made to the IRC by the Appropriations Act, 2001.

This bill would conform to the statutory change made by the Appropriations Act, 2001, to the definition of dependents and head of household.

25. Prevention of Duplication of Loss Through Assumption of Liabilities Giving Rise to Deduction

Generally, under federal and state laws no gain or loss is recognized when one or more persons transfer property to a corporation in exchange for stock and immediately after the exchange such person or persons control the corporation. However, a transfer recognizes gain to the extent it receives money or other property ("boot") as part of the exchange (sec. 351).

The assumption of liabilities by the controlled corporation generally is not treated as boot received by the transferor, except that the transferor recognizes gain to the extent that the liabilities assumed exceed the total of the adjusted basis of the property transferred to the controlled corporation pursuant to the exchange (sec. 357(c)).

The assumption of liabilities by the controlled corporation generally reduces the transferor's basis in the stock of the controlled corporation that assumed the liabilities. The transferor's basis in the stock of the controlled corporation is the same as the basis of the property contributed to the controlled corporation, increased by the amount of any gain (or dividend) recognized by the transferor on the exchange, and reduced by the amount of any money or property received and by the amount of any loss recognized by the transferor (sec. 358). For this purpose, the assumption of a liability is treated as money received by the transferor.

An exception to the general treatment of assumption of liabilities applies to assumptions of liabilities that would give rise to a deduction, provided the incurrence of such liabilities did not result in the creation or increase of basis of any property. The assumption of such liabilities is not treated as money received by the transferor in determining whether the transferor has gain on the exchange. Similarly, the transferor's basis in the stock of the controlled corporation is not reduced by the assumption of such liabilities. The Internal Revenue Service has ruled that the assumption by an accrual basis corporation of certain contingent liabilities for soil and groundwater remediation would be covered by this exception.

The Appropriations Act, 2001, contains a provision to limit the acceleration or duplication of losses through assumption of liabilities.

Under the Appropriations Act, 2001, if the basis of stock (determined without regard to this provision) received by a transferor as part of a tax-free exchange with a controlled corporation exceeds the fair market value of the stock, then the basis of the stock received is reduced (but not below the fair market value) by the amount (determined as of the date of the exchange) of any liability that (1) is assumed in exchange for such stock, and (2) did not otherwise reduced the transferor's basis of the stock by reason of the assumption. Except as provided by the Secretary of the Treasury, this provision does not apply where the trade or business with which the liability is associated is transferred to the corporation as part of the exchange, or where substantially all the assets which the liability is associated are transferred to the corporation as part of the exchange.

The exception for transfers of a trade or business, or substantially all the assets with which a liability is associated, are intended to obviate the need for valuation or basis reduction in such cases. The exceptions are not intended to apply to a situation involving the selective transfer of assets that may bear some relationship to the liability, but that do not represent the full scope of the trade or business (or substantially all the assets) with which the liability is associated.

For purposes of this provision, the term “liability” includes fixed or contingent obligation to make payments, without regard to whether such obligation or potential obligation is otherwise taken into account under the Code. The determination whether a liability (as more broadly defined for purposes of this provision) has been assumed is made in accordance with the provisions of section 357(d)(1) of the Code. Under the standard of 357(d)(1), a recourse liability is treated as assumed if, based on all the facts and circumstances, the transferee has agreed to and is expected to satisfy such liability (or portion thereof), whether or not the transferor has been relieved of the liability. For example, if a transferee corporation does not formally assume a recourse obligation or potential obligation of the transferor, but instead agrees and is expected to indemnify the transferor with respect to all or a portion of such an obligation, then the amount that is agreed to be indemnified is treated as assumed for purposes of the provision, whether or not the transferor has been relieved of such liability. Similarly, a nonrecourse liability is treated as assumed by the transferee of any asset subject to such liability.

The application of the provision is illustrated as follows: Assume a taxpayer transfers assets with an adjusted basis and fair market value of $100 to its wholly owned corporation and the corporation assumes $40 of liabilities (the payment of which would give rise to a deduction). Thus, the value of the stock received by the transferor is $60. Under present law, the basis of the stock would be $100. The provision requires that the basis of the stock be reduced to $60 (i.e., a reduction of $40). Except as provided by the Secretary, no basis reduction is required if the transferred assets consisted of the trade or business, or substantially all of the assets, with which the liability associated.

The provision does not change the tax treatment with respect to the transferee corporation.

The Secretary of the Treasury is directed to prescribe rules providing appropriate adjustments to prevent the acceleration or duplication of losses through the assumption of liabilities (as defined in the provision) in transactions involving partnerships. The Secretary may also provide appropriate adjustments in the case of transactions involving S corporations. In the case of S corporations, such rules may be applied instead of the otherwise applicable basis reduction rules.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to transfers of property for stock to a controlled corporation. California law has not conformed to the changes made to the IRC by the Appropriations Act, 2001.

This bill would conform to the Appropriations Act, 2001, changes made to transfers of property for stock to a controlled corporation, effective for transfers made after January 1, 2002.

26. Tax Treatment Of Securities Futures Contracts

Generally, under federal and state laws, gain or loss from the sale of property, including stock, is recognized at the time of sale or other disposition of the property, unless there is a specific statutory provision of nonrecognition (sec. 1001).

Gains and losses from the sale or exchange of capital assets are subject to special rules. In the case of individuals, net capital gain is generally subject to a maximum tax rate of 20% (sec. 1(h)). Net capital gain is the excess of net long-term capital gains over net short-term capital losses. Also, capital losses are allowed only to the extent of capital gains plus, in the case of individuals, $3,000 (sec. 1211). Capital losses of individuals may be carried forward indefinitely and capital losses of corporations may be carried back three years and forward five years (sec. 1212).

Generally, in order for gains or losses on a sale or exchange of a capital asset to be long-term capital gains or losses, the asset must be held for more than one year (sec. 1222). A capital asset generally includes all property held by the taxpayer, except certain enumerated types of property such as inventory (sec. 1221).

Section 1256 Contracts

Special rules apply to “section 1256 contracts,” which include regulated futures contracts, certain foreign currency contracts, nonequity options, and dealer equity options. Each section 1256 contract is treated as if it were sold (and repurchased) for its fair market value on the last business day of the year (i.e., “marked to market”). Any gain or loss with respect to a section 1256 contract that is subject to the mark-to-market rule is treated as if 40% of the gain or loss were short-term capital gain or loss and 60% were long-term capital gain or loss. This results in a maximum rate of 27.84% on any gain for taxpayers other than corporations. The mark-to-market rule (and the special 60/40 capital treatment) is inapplicable to hedging transactions.

A “regulated futures contract” is a contract (1) which is traded on or subject to the rules of a national securities exchange registered with the Securities Exchange Commission, a domestic board of trade designated a contract market by the Commodities Futures Trading Commission, or similar exchange, board of trade, or market, and (2) with respect to which the amount required to be deposited and which may be withdrawn depends on a system of marking to market.

A “dealer equity option” means, with respect to an options dealer, an equity option purchased in the normal course of the activity of dealing in options and listed on the qualified board or exchange on which the options dealer is registered. An equity option is an option to buy or sell stock or an option the value of which is determined by reference to any stock, group of stocks, or stock index, other than an option on certain broad-based groups of stock or stock index. An options dealer is any person who is registered with an appropriate national securities exchange as a market maker or specialist in listed options, or whom the Secretary of the Treasury determines performs functions similar to market makers and specialists.

Mark to Market Accounting for Dealers in Securities

Previously, a dealer in securities computed its income from dealing in securities pursuant to the mark-to-market method of accounting (sec. 475). Gains and losses are treated as ordinary income and loss. Traders in securities, and dealers and traders in commodities may elect to use this method of accounting, including the ordinary income treatment. Section 1256 contracts are not treated as securities for purposes of section 475.

Short Sales

In the case of a “short sale” (i.e., where the taxpayer sells borrowed property and later closes the sale by repaying the lender with substantially identical property), any gain or loss on the closing transaction is considered gain or loss from the sale or exchange of a capital asset if the property used to close the short sale is a capital asset in the hands of the taxpayer, but the gain is ordinarily treated as short-term gain (sec. 1233(a)).

The Code also contains several rules intended to prevent the transformation of short-term capital gain into long-term capital gain or long-term capital loss into short-term loss by simultaneously holding property and selling short substantially identical property (sec. 1233(b) and (d)). Under these rules, if a taxpayer holds property for less than the long-term holding period and sells short substantially identical property, any gain or loss upon the closing of the short sale is considered short-term capital gain, and the holding period of the substantially identical property is generally considered to begin on the date of the closing of the short sale. Also, if a taxpayer has held property for more than the long-term holding period and sells short substantially identical property, any loss on the closing of the short sale is considered a long-term capital loss.

For purposes of these short sale rules, property includes stock, securities, and commodity futures, but commodity futures are not considered substantially identical if they call for delivery in different months.

For purposes of the short-sale rules relating to short-term gains, the acquisition of an option to sell at a fixed price is treated as a short sale, and the exercise or failure to exercise the option is considered a closing of the short sale.

The Code also treats a taxpayer as recognizing gain where the taxpayer holds appreciated property and enters into a short sale of the same or substantially identical property, or enters into a contract to sell that same or substantially identical property (sec. 1259).

Wash Sales

The wash-sale rule (sec. 1091) disallows certain losses from the disposition of stock or securities if substantially identical stock or securities (or an option or contract to acquire such property) are acquired by the taxpayer during the period beginning 30 days before the date of sale and ending 30 days after such date of sale. Commodity futures are not treated as stock or securities for purposes of this rule. The basis of the substantially identical stock or securities is adjusted to include the disallowed loss.

Similar rules apply to disallow any loss realized on the closing of a short sale of stock or securities where substantially identical stock or securities are sold (or a short sale, option or contract to sell is entered into) during the applicable period before and after the closing of the short sale.

Straddle Rules

If a taxpayer realizes a loss with respect to a position in a straddle, the taxpayer may recognize that loss for the taxable year only to the extent that the loss exceeds the unrecognized gain (if any) with respect to offsetting positions in the straddle (sec. 1092). Disallowed losses are carried forward to the succeeding taxable year and are subject to the same limitation in that taxable year.

A “straddle” generally refers to offsetting positions with respect to actively traded personal property. Positions are offsetting if there is a substantial diminution of risk of loss from holding one position by reason of holding one or more other positions in personal property. A “position” in personal property is an interest (including a futures or forward contract or option) in personal property.

The straddle rules provide that the Secretary of the Treasury may issue regulations applying the short sale holding period rules to positions in a straddle. Temporary regulations have been issued setting forth the holding period rules applicable to positions in a straddle. To the extent these rules apply to a position, the rules in section 1233(b) and (d) do not apply.

The straddle rules generally do not apply to positions in stock. However the straddle rules apply if one of the positions is stock and at least one of the offsetting positions is either (1) an option with respect to stock or (2) a position with respect to substantially similar or related property (other than stock) as defined in Treasury regulations. Under proposed Treasury regulations, a position with respect to substantially similar or related property does not include stock or a short sale of stock, but includes any other position with respect to substantially similar or related property.

If a straddle consists of both positions that are section 1256 contracts and positions that are not such contracts, the taxpayer may designate the positions as a mixed straddle. Positions in a mixed straddle are not subject to the mark-to-market rule of section 1256, but instead are subject to rules written under regulations to prevent the deferral of tax or the conversion of short-term capital gain to long-term capital gain or long-term capital loss into short-term capital loss.

Transactions by a Corporation in its Own Stock

A corporation does not recognize gain or loss on the receipt of money or other property in exchange for its own stock. Likewise, a corporation does not recognize gain or loss when it redeems its stock with cash, for more or less than it received when the stock was issued. In addition, a corporation does not recognize gain or loss on any lapse or acquisition or an option to buy or sell its stock (sec. 1032).

The Appropriations Act, 2001, provides that, except in the case of dealer securities futures contracts described below, securities futures contracts are not treated as section 1256 contracts. Thus, holders of these contracts are not subject to the mark-to-market rules of section 1256 and are not eligible for 60-percent long-term capital gain treatment under section 1256. Instead, gain or loss on these contracts will be recognized under the general rules relating to the disposition of property.
A securities futures contract is defined by reference to section 3(a)(55)(A) of the Securities Exchange Act of 1934, and is added by the Appropriations Act, 2001, to the Code. In general, that definition provides that a securities futures contract means a contract of sale for future delivery of a single security or a narrow-based security index. A securities futures contract will not be treated as a commodities futures contract for purposes of the Code.

Treatment of Gains and Losses

The Appropriations Act, 2001, provides that any gain or loss from the sale or exchange of a securities futures contract (other than a dealer securities futures contract) will be considered as gain or loss from the sale or exchange of property which has the same character as the property to which the contract relates has (or would have) in the hands of the taxpayer. Thus, if the underlying security would be a capital asset in the taxpayer's hands, then gain or loss from the sale or exchange of the securities futures contract would be capital gain or loss. The Appropriations Act, 2001, also provides that the termination of a securities futures contract that is a capital asset will be treated as a sale or exchange of the contract.

Capital gain treatment will not apply to contracts which themselves are not capital assets because of the exceptions to the definition of a capital asset relating to inventory (sec. 1221(a)(1)) or hedging (sec. 1221(a)(7)), or to any income derived in connection with a contract which would otherwise be treated as ordinary income.

Except as otherwise provided in regulations under section 1092(b) (which treats certain losses from a straddle as long term capital losses) and section 1234B, as added by the Appropriations Act, 2001, any capital gain or loss from the sale or exchange of a securities futures contract to sell property (i.e., the short side of a securities futures contract) will be short-term capital gain or loss. In other words, a securities futures contract to sell property is treated as equivalent to a short sale of the underlying property.

Wash Sale Rules

The Appropriations Act, 2001, clarifies that, under the wash sale rules, a contract or option to acquire or sell stock or securities shall include options and contracts that are (or may be) settled in cash or property other than the stock or securities to which the contract relates. Thus, for example, the acquisition, within the period set forth in section 1091, of a securities futures contract to acquire stock of a corporation could cause the taxpayer's loss on the sale of stock in that corporation to be disallowed, notwithstanding that the contract may be settled in cash.

Short Sale Rules

In applying the short sale rules, a securities futures contract to acquire property will be treated in a manner similar to the property itself. Thus, for example, the holding of a securities futures contract to acquire property and the short sale of property that is substantially identical to the property under the contract will result in the application of the rules of section 1233(b). In addition, as stated above, a securities futures contract to sell is treated in a manner similar to a short sale of the property.
Straddle Rules

Stock that is part of a straddle where at least one of the offsetting positions is a securities futures contract with respect to the stock or substantially identical stock will be subject to the straddle rules of section 1092. Treasury regulations under section 1092 applying the principles of the section 1233(b) and (d) short sale rules to positions in a straddle will also apply.

For example, assume a taxpayer holds a long-term position in actively traded stock (which is a capital asset in the taxpayer's hands) and enters into a securities futures contract to sell substantially identical stock (at a time when the position in the stock has not appreciated in value so that the constructive sale rules of section 1259 do not apply). The taxpayer has a straddle. Treasury regulations prescribed under section 1092(b) applying the principles of section 1233(d) will apply, so that any loss on closing the securities futures contract will be a long-term capital loss.

Section 1032

A corporation will not recognize gain or loss on transactions in securities futures contracts with respect to its own stock.

Holding Period

If property is delivered in satisfaction of a securities futures contract to acquire property (other than a contract to which section 1256 applies), the holding period for the property will include the period the taxpayer held the contract, provided that the contract was a capital asset in the hands of the taxpayer.

Regulations

The Secretary of the Treasury or his delegate has the authority to prescribe regulations to provide for the proper treatment of securities futures contracts under provisions of the IRC.

Dealers in Securities Futures Contracts

In general, the Appropriations Act, 2001, provides that securities futures contracts and options on such contracts are not section 1256 contracts. The Appropriations Act, 2001, provides, however, that "dealer securities futures contracts" will be treated as section 1256 contracts.

The term ''dealer securities futures contract" means a securities futures contract which is entered into by a dealer in the normal course of his or her trade or business activity of dealing in such contracts, and is traded on a qualified board of trade or exchange. The term also includes any option to enter into securities futures contracts purchased or granted by a dealer in the normal course of his or her trade or business activity of dealing in such options. The determination of who is to be treated as a dealer in securities futures contracts is to be made by the Secretary of the Treasury or his delegate not later than July 1, 2001. Accordingly, the Appropriations Act, 2001 authorizes the Secretary to treat a person as a dealer in securities futures contracts or options on such contracts if the Secretary determines that the person performs, with respect to such contracts or options, functions similar to an equity options dealer, as defined under present law.

The determination of who is a dealer in securities futures contracts is to be made in a manner that is appropriate to carry out the purposes of the provision, which generally is to provide comparable tax treatment between dealers in securities futures contracts, on the one hand, and dealers in equity options, on the other. Although traders in securities futures contracts (and options on such contracts) may not have the same market-making obligations as market makers or specialists in equity options, many traders are expected to perform analogous functions to such market makers or specialists by providing market liquidity for securities futures contracts (and options) even in the absence of a legal obligation to do so.

Accordingly, the absence of market-making obligations is not inconsistent with a determination that a class of traders are dealers in securities futures contracts (and options), if the relevant factors, including providing market liquidity for such contracts (and options), indicate that the market functions of the traders is comparable to that of equity options dealers.

As in the case of dealer equity options, gains and losses allocated to any limited partner or limited entrepreneur with respect to a dealer securities futures contract will be treated as short-term capital gain or loss.

Treatment of Options Under Section 1256

The Appropriations Act, 2001, modifies the definition of “equity option” for purposes of section 1256 to take into account changes made by the non-tax provisions of the Appropriations Act, 2001. Only options dealers are eligible for section 1256 with respect to equity options. The term “equity option” is modified to include an option to buy or sell stock, or an option the value of which is determined, directly or indirectly, by reference to any stock, or any “narrow-based security index,” as defined in section 3(a)(55) of the Securities Exchange Act of 1934 (as modified by the Appropriations Act, 2001). An equity option includes an option with respect to a group of stocks only if the group meets the requirements for a narrow based security index.

As under present law, listed options that are not “equity options” are considered “nonequity options” to which section 1256 applies for all taxpayers. For example, options relating to broad-based groups of stocks and broad based stock indexes will continue to be treated as nonequity options under section 1256.

Definition of Contract Markets

The non-tax provisions of the Appropriations Act, 2001, designate certain new contract markets. The new contract markets will be contract markets for purposes of the Code, except to the extent provided in Treasury regulations.

<u>California Law</u>

California law is in conformity with federal law as it read on January 1, 1998, as it relates to securities futures contracts. California law has not conformed to the changes made to the IRC by the Appropriations Act, 2001.

The bill would conform to the Appropriations Act, 2001, changes to securities futures contracts.

27. Federal Technical Changes

Numerous technical changes were made to the IRC in 1998. Where California law is in conformity with the underlying federal provision affected by the technical change, this bill would conform to the technical change. The effective dates for the technical changes are either the later of the effective date for federal law or the effective date that California adopted the underlying federal law. This bill would conform to the following technical changes:

Clarification of the Deduction for Student Loan Interest (IRS Reform Act § 6004(b)). The provision clarifies that the student loan interest deduction may be claimed only by a taxpayer who is legally obligated to make the interest payments pursuant to the terms of the loan.

Clarification of Qualified State Tuition Programs (IRS Reform Act § 6004(c)). The provision clarifies that distributions from qualified state tuition programs are treated as representing a pro-rata share of the principal (i.e., contributions) and accumulated earnings in the account.

In addition, the provision clarifies that for purposes of tax-free rollovers and changes of designated beneficiaries, a "member of the family" includes the spouse of the original beneficiary.

Clarification of Education IRAs (IRS Reform Act § 6004(d)). The provision provides that any balance remaining in an education IRA will be deemed to be distributed within 30 days after the date that the designated beneficiary reaches age 30 (or, if earlier, within 30 days of the date that the beneficiary dies). The provision further clarifies that, in the event of the death of the designated beneficiary, the balance remaining in an education IRA may be distributed (without imposition of the additional 10% tax) to any other (i.e., contingent) beneficiary under the age of 30 or to the estate of the deceased designated beneficiary.

If any member of the family of the deceased beneficiary becomes the new designated beneficiary of an education IRA, then no tax will be imposed on such redesignation and the account will continue to be treated as an education IRA.

The provision also clarifies that for purposes of the special rules regarding tax-free rollovers and changes of designated beneficiaries, the new beneficiary must be under the age of 30.

Under the provision, the additional 10% tax on unqualified distributions will not apply to a distribution from an education IRA, which (although used to pay for qualified higher education expenses) is includible in the beneficiary's gross income solely because the taxpayer elects to claim a HOPE or Lifetime Learning credit with respect to the beneficiary. The provision further provides that the additional 10% tax will not apply to the distribution of any contribution to an education IRA made during a taxable year if the distribution is made on or before the date that a return is required to be filed (including extensions of time) by the beneficiary for the taxable year during which the contribution was made. If the beneficiary is not required to file such a return, the return is deemed to be required on April 15th of the year following the taxable year during which the contribution was made.

In addition, the provision provides that the 10% excise tax penalty applies under that section for each year that an excess contribution remains in an education IRA (and not merely the year that the excess contribution is made).

The provision clarifies that, in order for taxpayers to establish an education IRA, the designated beneficiary must be a "life-in-being." The provision also clarifies that, under annuity rules contained in present-law IRC Sec. 72, distributions from education IRAs are treated as representing a pro-rata share of the principal (i.e., contributions) and accumulated earnings in the account.

In addition, regarding the exclusion from income of interest earned from U.S. Savings Bonds used to pay for higher education tuition and fees, the provision broadens the definition of higher education tuition and fees to conform to the definition used in education IRAs and state tuition programs.

Clarification of the Enhanced Deduction for Corporate Contributions of Computer Technology and Equipment (IRS Reform Act § 6004(e)). The provision clarifies the special rule applies to contributions made during taxable years beginning after December 31, 1997, and before December 31, 2000.

In addition, the provision clarifies that the requirements of “qualified elementary or secondary educational contributions” apply regardless of whether the recipient is an educational organization or a tax-exempt charitable entity.

Note: The revenue loss was included in AB 2797 (Stat. 1998, Ch. 322) as if the enhanced deduction for the computer technology and equipment was available to corporations for income years beginning after December 31, 1997, and before January 1, 2001. A $4 million loss was attributed to that bill.

Clarification of the Cancellation of Certain Student Loans (IRS Reform Act § 6004(f)). The provision clarifies that gross income does not include amounts from the forgiveness of loans made by educational organizations and certain tax-exempt organizations to refinance any existing student loan (and not just loans made by educational organizations).

In addition, the provision clarifies that refinancing loans made by educational organizations and certain tax-exempt organizations must be made pursuant to a program of the refinancing organization (e.g., school or private foundation) that requires the student to fulfill a public service work requirement.

Clarification of Limitations for Active Participation in an IRA (IRS Reform Act § 6005(a)). The provision clarifies the intent of the Tax Relief Act of 1997 relating to the AGI phase-out ranges for married individuals who are active participants in employer-sponsored plans and the AGI phase-out range for spouses of such active participants.

Clarification of the Penalty-Free Distributions for Education Expenses and Purchase of First Homes (IRS Reform Act § 6005(c)). The provision modifies the rules relating to the ability to roll over hardship distributions from certain employer-sponsored retirement plans to prevent avoidance of the 10% early withdrawal tax.

Distributions from cash or deferred arrangements and similar arrangements made on account of hardship of the employee are not eligible rollover distributions. Such distributions will not be subject to the 20% withholding applicable to eligible rollover distributions.

Rollover of Gain from Sale of Qualified Stock (IRS Reform Act § 6005(f)). Under the provision, a partnership or an S corporation can roll over gain from qualified small business stock held more than six months only if at all times during the taxable year all the interests in the partnership or S corporation are held by individuals, estates, and trusts with no corporate beneficiaries. The term "estate" is intended to include both the estate of a decedent and the estate of an individual in bankruptcy.

The provision also provides that the benefit of a tax-free rollover with respect to the sale of small business stock by a partnership will flow through to a partner who is not a corporation if the partner held its partnership interest at all times the partnership held the small business stock. A similar rule applies to S corporations.

Election to Use AMT Depreciation for Regular Tax Purposes (IRS Reform Act § 6006(b)). For property placed in service after 1998, a taxpayer is allowed to elect, for regular tax purposes, to compute depreciation on tangible personal property otherwise qualified for the 200% declining balance method by using the 150% declining balance method over the recovery periods applicable to the regular tax (rather than the longer class lives of the alternative depreciation system (ADS) of IRC Sec. 168(g)).

Depreciation Limitations for Electric Vehicles (IRS Reform Act § 6009(c)). Annual depreciation deductions with respect to passenger automobiles are limited to specified dollar amounts, indexed for inflation. Any cost not recovered during the six-year recovery period (the recovery period) of such vehicles may be recovered during the years succeeding the recovery period, subject to similar limitations.

Current law provides the recovery period limitations are trebled for vehicles that are propelled primarily by electricity.

The provision provides that the depreciation limitations applicable to post-recovery periods under IRC Sec. 280F are trebled for vehicles that are propelled primarily by electricity.

Clarification of Constructive Sales Rules (IRS Reform Act § 6010(a)). The provision clarifies that, to qualify for the exception for positions with respect to debt instruments, the position would either have to meet the requirements as to unconditional principal amount, non-convertibility and interest terms or, alternatively, be a hedge of a position meeting these requirements. A hedge for purposes of the provision includes any position that reduces the taxpayer's risk of interest rate or price changes or currency fluctuations with respect to another position.

The provision also clarifies that the definition of a forward contract includes a contract that provides for cash settlement with respect to a substantially fixed amount of property at a substantially fixed price.

Additionally, the provision clarifies that the special effective date rule does not apply if the constructive sale transaction is closed at any time prior to the end of the 30th day after the date of enactment of the Tax Relief Act of 1997.

Treatment of Mark-to-Market Gains of Electing Traders (IRS Reform Act § 6010(a)). The provision clarifies that gain or loss of a securities or commodities trader that is treated as ordinary solely by reason of election of mark-to-market treatment is not treated as other than gain or loss from a capital asset for purposes of determining "net earnings from self-employment" for the Self-Employed Contributions Act tax purposes, determining whether the passive-type income exception to the publicly-traded partnership rules is met, or for purposes of any other IRC provision specified by the Treasury Department in regulations.

Treatment of Certain Corporate Distributions (IRS Reform Act § 6010(c)). The provision clarifies that the acquisitions described in IRC Sec. 355(e)(3)(A) are disregarded in determining whether there has been an acquisition of a 50% or greater interest in a corporation. However, other transactions that are part of a plan or series of related transactions could result in an acquisition of a 50% or greater interest.

In the case of acquisitions under IRC Sec. 355(e)(3)(A)(iv), the provision clarifies that the acquisition of stock in the distributing corporation or any controlled corporation is disregarded to the extent that the percentage of stock owned directly or indirectly in the corporation by each person owning stock in the corporation immediately before the acquisition does not decrease.

Certain Preferred Stock Treated as "Boot" (IRS Reform Act § 6010(e)). The provision provides that the statutory period for the assessment of any deficiency attributable to a corporation failing to be a family-owned corporation shall not expire before the expiration of three years after the date the Secretary of the Treasury is notified by the corporation (in such manner as the Secretary may prescribe) of such failure, and such deficiency may be assessed before the expiration of such three-year period notwithstanding the provisions of any other law or rule of law which would otherwise prevent such assessment.

The provision also clarifies that IRC Sec. 351(b), relating to the receipt of property, applies to a transferor who transfers property in an IRC Sec. 351 exchange and receives nonqualified preferred stock in addition to stock that is not treated as "other property" under that section. Thus, if a transferor received only nonqualified preferred stock but the transaction in the aggregate otherwise qualified as an IRC Sec. 351 exchange, such a transferor would recognize loss and the basis of the nonqualified preferred stock and of the property in the hands of the transferee corporation would reflect the transaction in the same manner as if that particular transferor had received solely "other property" of any other type.

Modify UBI Rules Applicable to Second-Tier Subsidiaries (IRS Reform Act § 6010(j). The provision clarifies that rent, royalty, annuity, and interest income that would otherwise be excluded from "unrelated business income" (UBI) is included in UBI if such income is received or accrued from a taxable or tax-exempt subsidiary that is controlled by the parent tax-exempt organization. The provision further clarifies that the provision does not apply to any payment received or accrued during the first two taxable years beginning on or after the date of enactment if such payment is received or accrued pursuant to a binding written contract in effect on June 8, 1997, and at all times thereafter before such payment (but not pursuant to any contract provision that permits optional accelerated payments).

Clarification of Allocation of Basis of Properties Distributed to a Partner by a Partnership (IRS Reform Act § 6010(m)). The technical correction clarifies that for purposes of the allocation rules of IRC Sec. 732(c), "unrealized receivables" has the meaning in IRC Sec. 751(c) including the last two sentences of IRC Sec. 751(c), relating to items of property that give rise to ordinary income. Thus, in applying the allocation rules of IRC Sec. 732(c) to property listed in the last two sentences of IRC Sec. 751(c), such as property giving rise to potential depreciation recapture, the amount of unrealized appreciation in any such property does not include any amount that would be treated as ordinary income if the property were sold at fair market value, because such amount is treated as a separate asset for purposes of the basis allocation rules.

Clarification of Expanding the Limitations on Deductibility of Premiums and Interest with Respect to Life Insurance, Endowment and Annuity Contracts (IRS Reform Act § 6010(o)). The technical correction clarifies that if coverage for each insured individual under a master contract is treated as a separate contract for purposes of IRC Sec. 817(h), 7702, and 7702A, then coverage for each such insured individual is treated as a separate contract for purposes of the exception to the pro rata interest disallowance rule for a policy or contract covering an individual who is a 20% owner, employee, officer or director of the trade or business at the time first covered. A master contract does not include any contract if the contract (or any insurance coverage provided under the contract) is a group life insurance contract within the meaning of IRC Sec. 848(e)(2). No inference is intended that coverage provided under a master contract, for each such insured individual, is not treated as a separate contract for each such individual for other purposes under present law.

The technical correction clarifies that the required reporting to the Treasury Secretary is an information return and any reporting required to be made to any other person is a payee statement.

Thus, the $50-per-report penalty imposed for failure to file or provide such an information return or payee statement applies. It is clarified that the Treasury Secretary may require reporting by the issuer or policyholder of any relevant information either by regulations or by any other appropriate guidance (including but not limited to publication of a form).

The technical correction clarifies that the treatment of additional covered lives under the effective date of the TRA of 1997 provision applies only with respect to coverage provided under a master contract, provided that coverage for each insured individual is treated as a separate contract for purposes of IRC Sec. 817(h), 7702 and 7702A, and the master contract or any coverage provided thereunder is not a group life insurance contract within the meaning of IRC Sec. 848(e)(2).

Information Reporting with Respect to Certain Foreign Corporations and Partnerships (IRS Reform Act § 6011(f)). The provision provides clarification and guidance relating to the furnishing of required information to be provided by the Secretary of the Treasury (not specifically through regulations) and conforms the use of the defined term "foreign business entity."

Travel Expenses of Federal Employees Participating in a Federal Criminal Investigation (IRS Reform Act § 6012(a)). The provision clarifies that prosecuting a federal crime or providing support services to the prosecution of a federal crime is considered part of investigating a federal crime, thus permitting these employees to deduct their travel expenses.

Modification of Distribution Rules for REITs (IRS Reform Act § 6012(g)). The provision amends the simplification provision to provide that any distribution from a REIT will be deemed to first come from earnings and profits that were generated when the entity did not qualify as a REIT. The provision does not change the requirement that a REIT must distribute 95% of its REIT earnings, or any other requirement.

Provision of Regulatory Authority for Simplified Reporting of Funeral Trusts Terminated During the Taxable Year (IRS Reform Act § 6013(b)). The provision clarifies that a pre-need funeral trust may continue to qualify for these special rules for the 60-day period after the decedent's death, even though the trust ceases to be a grantor trust during that time.

Treatment of Certain Disability Payments to Public Safety Employees (IRS Reform Act § 6015(c)). In order to address problems taxpayers are encountering with the IRS in seeking refunds under the old provision, the new provision clarifies the scope of the provision.

The provision provides that payments made on account of heart disease or hypertension of the employee received in 1989, 1990, or 1991 pursuant to a state law as described under present law, or received by an individual referred to in the state law under any other statute, ordinance, labor agreement, or similar provision as a disability pension payment or in the nature of a disability pension payment attributable to employment as a police officer or as a fireman, will be excludable from income.

Application of Requirements for SIMPLE IRAs in the Case of Mergers and Acquisitions (IRS Reform Act § 6016(a)). The provision conforms the treatment applicable to SIMPLE IRAs upon acquisition, disposition or similar transactions for purposes of (1) the 100 employee limit, (2) the exclusive plan requirement, and (3) the coverage rules for participation.

In the event of such a transaction, the employer will be treated as an eligible employer and the arrangement will be treated as a qualified salary reduction arrangement for the year of the transaction and the two following years, provided rules similar to the rules of IRC Sec. 410(b)(6)(C)(i) are satisfied and the arrangement would satisfy the requirements to be a qualified salary reduction arrangement after the transaction if the trade or business that maintained the arrangement prior to the transaction had remained a separate employer.

Treatment of Indian Tribal Governments (IRS Reform Act § 6016(a)). The provision clarifies that an employee participating in an IRC Sec. 403(b)(7) custodial account of the Indian tribal government may roll over amounts from such account to an IRC Sec. 401(k) plan maintained by the Indian tribal government.

Disclosure of Returns and Return Information (IRS Reform Act § 6019(c)). The provision clarifies that disclosures to one ex or estranged spouse, whether there has been an attempt to collect the deficiency from the other ex or estranged spouse, that, like certain other disclosures permitted under present law, may be made to the duly authorized attorney in fact of the person making the disclosure request.

Treatment of Interest on Qualified Education Loans (Trade and Extenders Act § 4003(a)). The provision clarifies that otherwise deductible qualified education loan interest is not treated as nondeductible personal interest. The provision also clarifies that, for purposes of phasing out the deduction, modified AGI is determined after application of IRC Sec. 135 (relating to income from certain U.S. savings bonds) and IRC Sec. 137 (relating to adoption assistance programs).

The provision also provides that a qualified education loan does not include any indebtedness owed to any person by reason of a loan under any qualified employer plan or under any contract purchased under a qualified employer plan.

Abatement of Interest by Reason of Presidentially Declared Disasters (Trade and Extenders Act § 4003(e)). Under a provision of the TRA of 1997, if the Secretary of the Treasury extends the filing date of an individual tax return for individuals living in an area that has been declared a disaster area by the President during 1997, no interest is charged as a result of the failure of the individual taxpayer to file an individual tax return, or to pay the taxes shown on such return, during the extension period. The 1998 provision extends the rule so that it is available for disasters declared in 1997 or 1998 with respect to the 1997 tax year.

Determination of Unborrowed Policy Cash Value Under COLI Pro Rata Interest Disallowance Rules (Trade and Extenders Act § 4003(i)). The provision clarifies the meaning of "unborrowed policy cash value" with respect to any life insurance, annuity or endowment contract.

The technical correction clarifies that if the cash surrender value (determined without regard to any surrender charges) with respect to any policy or contract does not reasonably approximate its actual value, then the amount taken into account for this purpose is the greater of (1) the amount of the insurance company's liability with respect to the policy or contract, as determined for purposes of the annual statement approved by the National Association or Insurance Commissioners, (2) the amount of the insurance company's reserve with respect to the policy or contract for purposes of such annual statement; or (3) such other amount as is determined by the Treasury Secretary.

Casualty Loss Deductions (Trade and Extenders Act § 4004). The provision clarifies that all deductions for nonbusiness casualty and theft losses are taken into account in computing an NOL. Also, these deductions are not treated as miscellaneous itemized deductions subject to the 2% adjusted gross income floor, or as itemized deductions subject to the overall limitation on itemized deductions, and are allowed to nonresident aliens.

Technical Amendments Made by the Appropriations Act, 2001, Relating to the Ticket to Work and Work Incentives Improvement Act of 1999

Research credit. The provision clarifies the anti-double dip rule coordinating the research credit (sec. 41) and the Puerto Rico economic activity credit (sec. 30A). It is arguable that the present-law provisions could be construed so that the amount of wages on which a taxpayer could claim the section 30A credit is reduced only by the amount of credit claimed under section 41, rather than by the amount of wages upon which the section 41 credit is based. This result is inconsistent with the legislative history of the original provisions. The provision deletes the words “or credit” after “deduction” in section 280C(c)(1), and adds a new subsection in section 30A specifying that wages or other expenses taken into account for section 30A may not be taken into account for section 41.

Taxable REIT subsidiaries. The provision clarifies that a REIT’s redetermined rents (described in sec. 857(b)(7)(B)) that are subject to tax under section 857(b)(7)(A) do not include amounts received from a taxable REIT subsidiary that would be excluded from unrelated business taxable income (under sec. 512(b)(3), relating to certain rents, if received by certain types of organizations described in sec. 511(a)(2)).

Partnership basis adjustments. The provision provides that the rule in the consolidated return regulations (Treas. Reg. sec. 1.1502-34) aggregating stock ownership for purposes of section 332 (relating to complete liquidation of a subsidiary that is a controlled corporation) also applies for purposes of section 732(f) (relating to basis adjustments to assets of a controlled corporation received in a partnership distribution).

Technical Amendments Made by the Appropriations Act, 2001, Related to the Taxpayer Relief Act of 1997

Straight-line depreciation under AMT. The provision clarifies that the Taxpayer Relief Act of 1997 did not change the requirement that the straight-line method of depreciation be used in computing the alternative minimum tax ("AMT") depreciation allowance for section 1250 property. It is arguable that the changes made by Taxpayer Relief Act could be read as inadvertently allowing accelerated depreciation under the AMT for section 1250 property that is allowed accelerated depreciation under the regular tax.

Transportation benefits. Salary reduction amounts are generally treated as compensation for purposes of the limits on contributions and benefits under qualified plans. In addition, an employer can elect whether or not to include such amounts for nondiscrimination testing purposes. The IRS Reform Act permitted employers to offer a cash option in lieu of qualified transportation benefits. The Appropriations Act, 2001, treats salary reduction amounts used for qualified transportation benefits the same as other salary reduction amounts for purposes of defining compensation under the qualified plan rules.

Technical Amendments Made by the Appropriations Act, 2001, Related to the Small Business Job Protection Act of 1996

Electing small business trusts holding S corporation stock. The provision allows an electing small business trust (sec. 1361(e)) to have an organization described in section 170(c)(1) (relating to state and local governments) as a beneficiary if the organization holds a contingent interest and is not a potential current beneficiary.

Definition of lump-sum distribution. Section 1401(b) of the Small Business Job Protection Act of 1996 Act repealed five-year averaging for lump-sum distributions. The definition of lump-sum distribution was preserved for other provisions, primarily those relating to certain arrangements in employer securities. The definition was moved from section 402(d)(4)(A) to section 402(e)(4)(D)(i). This definition included the following sentence: "A distribution of an annuity contract from a trust or annuity plan referred to in the first sentence of this subparagraph shall be treated as a lump sum distribution." The Appropriations Act, 2001, adds this language back into the definition of lump-sum distribution. The sentence is relevant to section 401(k)(1)(B), which permits certain distributions if made as a "lump-sum distribution."

IRAs for nonworking spouses. Section 1427 of the Small Business Job Protection Act of 1996 expanded the IRA deduction for nonworking spouses. The maximum permitted IRA contribution is generally limited by the individual's earned income. Previously, it was possible for a nonworking (or lesser earning) spouse to make IRA contributions in excess of the couple's combined earned income. The following example illustrates previous law.

Example: Suppose H and W retire in the middle of January 1999. In that year, H earns $1,000 and W earns $500. Both are active participants in an employer-sponsored retirement plan. Their modified AGI is $60,000. They make no Roth IRA contributions. Before application of the income phase-out rules, the maximum deductible IRA contribution that H can make is $1,000 (sec. 219(b)(1)). After application of the income phase-out rule in section 219(g), H's maximum contribution is $200, and H contributes that amount to an IRA. Under 408(o)(2)(B), H can make nondeductible contributions of $800 ($1,000-$200).

W's maximum permitted deductible contribution under section 219(c)(1)(B), before the income phase-out, is $1,300 (the sum of H and W's earned income ($1,500) less H's deductible IRA contribution ($200)). Under the income phase-out, W's deductible contribution is limited to $200, and she can make a nondeductible contribution of $1,100 ($1,300-$200).

The total permitted contributions for H and W are $2,400 ($1,100 for H plus $1,300 for W). The combined contribution should have been limited to $1,500, the combined earned income of the spouses.

The Appropriations Act, 2001, provides that the contributions for the spouse with the lesser income cannot exceed the combined earned income of both spouses.

Technical Amendments Made by the Appropriations Act, 2001, Related to the Revenue Reconciliation Act of 1990

Qualified tertiary injectant expenses. The provision clarifies that the enhanced oil recovery credit (sec. 43) applies with respect to qualified tertiary injectant expenses described in section 193(b) that are paid or incurred in connection with a qualified enhanced oil recovery project, and that are deductible for the taxable year (regardless of the provision allowing the deduction). Purchased and self-produced injectants are treated the same for purposes of the section 43 credit.

Technical Amendments Made by the Appropriations Act, 2001, to Other Acts

Insurance. The legislative history of section 7702A(a) (enacted in the Technical and Miscellaneous Revenue Act of 1988) indicated that if a life insurance contract became a modified endowment contract ("MEC"), then the MEC status could not be eliminated by exchanging the MEC for another contract. Section 7702A(a)(2), however, arguably might have been read to allow a policyholder to exchange a MEC for a contract that does not fail the seven-pay test of section 7702A(b), then exchange the second contract for a third contract, which would not literally have been received in exchange for a contract that failed to meet the seven-pay test. The Appropriations Act, 2001 clarifies section 7702A(a)(2) to correspond to the legislative history, effective as if enacted with the Technical and Miscellaneous Revenue Act of 1988 (generally, for contracts entered into on or after June 21, 1988).

Insurance. Under section 7702A, if a life insurance contract that is not a modified endowment contract is actually or deemed exchanged for a new life insurance contract, then the seven-pay limit under the new contract is first computed without reference to the premium paid using the cash surrender value of the old contract. Then, it would be reduced by 1/7 of the premium paid taking into account the cash surrender value of the old contract.

For example, if the old contract had a cash surrender value of $14,000 and the seven-pay premium on the new contract would equal $10,000 per year but for the fact that there was an exchange, the seven-pay premium on the new contract would equal $8,000 ($10,000-$14,000/7). However, section 7702A(c)(3)(A) arguably might have been read to suggest that if the cash surrender value on the new contract was $0 in the first two years (due to surrender charges), then the seven-pay premium might be $10,000 in this example, unintentionally permitting policyholders to engage in a series of "material changes" to circumvent the premium limitations in section 7702A. The Appropriations Act, 2001, clarifies section 7702A(c)(3)(A) to refer to the cash surrender value of the old contract, effective as if enacted with the Technical and Miscellaneous Revenue Act of 1988 (generally, for contracts entered into on or after June 21, 1988).

Worthless securities. Section 165(g)(3) provides a special rule for worthless securities of an affiliated corporation. The test for affiliation in section 165(g)(3)(A) is the 80 percent vote test for affiliated groups under section 1504(a) that was in effect prior to 1984. When section 1504(a) was amended in the Deficit Reduction Act of 1984 to adopt the vote and value test of present law, no corresponding change was made to section 165(g)(3)(A), even though the tests had been identical until then. The Appropriations Act, 2001, conforms the affiliation test of section 165(g)(3)(A) to the test in section 1504(a)(2), effective for taxable years beginning after December 31, 1984.

Exception for certain annuities under OID rules. The Deficit Reduction Act of 1984 expanded the prior law rules for inclusion in income of original issue discount ("OID") on debt instruments. It provided an exception from the definition of a debt instrument for certain annuity contracts, including any annuity contract to which section 72 applies and that is issued by an insurance company subject to tax under subchapter L of the Code (and that meets certain other requirements). (See sec. 1275(a)(1)(B)(ii).) The Appropriations Act, 2001, clarifies that an annuity contract otherwise meeting the applicable requirements also comes within the exception of section 1275(a)(1)(B)(ii) if it is issued by an entity described in section 501(c) and exempt from tax under section 501(a), that would be subject to tax as an insurance company under subchapter L if it were not exempt under section 501(a).

For example, the Appropriations Act, 2001 clarifies that an annuity contract otherwise meeting the requirements that is issued by a fraternal beneficiary society which is exempt from federal income tax under section 501(a), and which is described in section 501(c)(8), comes within the exception under section 1275(a)(1)(B)(ii). It is understood that charitable gift annuities (as defined in sec. 501(m)) depend (in whole or in substantial part) on the life expectancy of one or more individuals, and thus come within the exception under section 1275(a)(1)(B)(i). This provision is effective as if included with section 41 of the Deficit Reduction Act of 1984 (i.e., for taxable years ending after July 18, 1984).

Technical Amendments Made by Job Creation Act of 2002 Related to EGTRRA,

Individual Retirement Arrangements ("IRAs").-- Under EGTRRA, a qualified employer plan may provide for voluntary employee contributions to a separate account that is deemed to be an IRA. The provision clarifies that, for purposes of deemed IRAs, the term "qualified employer plan" includes the following types of plans maintained by a governmental employer: a qualified retirement plan under section 401(a), a qualified annuity plan under section 403(a), a tax-sheltered annuity plan under section 403(b), and an eligible deferred compensation plan under section 457(b). The provision also clarifies that the Employee Retirement Income Security Act ("ERISA") is intended to apply to a deemed IRA in a manner similar to a simplified employee pension ("SEP").

Increase in benefit and contribution limits.--Under EGTRRA, the benefit and contribution limits that apply to qualified retirement plans are increased. These increases are generally effective for years beginning after December 31, 2001, but the increase in the limit on benefits under a defined benefit plan is effective for years ending after December 31, 2001. In the case of some plans that incorporate the benefit limits by reference and that use a plan year other than the calendar year, the increased benefit limits became effective under the plan automatically, causing unintended benefit increases. The provision permits an employer to amend such a plan by June 30, 2002, to reduce benefits to the level that applied before enactment of EGTRRA without violating the anticutback rules that generally apply to plan amendments. In connection with the increases in the benefit and contribution limits under EGTRRA, a new base period applies in indexing the 2002 dollar amounts for future cost-of-living adjustments. The same indexing method applies to the dollar amounts used to determine eligibility to participate in a SEP and to determine the proper period for distributions from an employee stock ownership plan ("ESOP"). The provision changes these dollar amounts to the 2002 indexed amounts so that future indexing will operate properly.

Modification of top-heavy rules.--Under EGTRRA, in determining whether a plan is topheavy, distributions made because of separation from service, death, or disability are taken into account for one year after distribution. Other distributions are taken into account for five years. EGTRRA also permits distributions from a section 401(k) plan, a tax-sheltered annuity plan, or an eligible deferred compensation plan to be made when the participant has a severance from employment (rather than separation from service).

The provision clarifies that distributions made after severance from employment (rather than separation from service) are taken into account for only one year in determining top-heavy status.

Elective deferrals not taken into account for deduction limits.--The provision clarifies that elective deferrals to a SEP are not subject to the deduction limits and are not taken into account in applying the limits to other SEP contributions. The provision also clarifies that the combined deduction limit of 25 percent of compensation for qualified defined benefit and defined contribution plans does not apply if the only amounts contributed to the defined contribution plan are elective deferrals.

Deduction limits.--Under present law, contributions to a SEP are included in an employee's income to the extent they exceed the lesser of 15 percent of compensation or $40,000 (for 2002), subject to a reduction in some cases. Under prior law, the annual limitation on the amount of deductible contributions to a SEP was 15 percent of compensation. Under EGTRRA, the annual limitation on the amount of deductible contributions that can be made to a SEP is increased from 15 percent of compensation to 25 percent of compensation. The provision makes a conforming change to the rule that limits the amount of SEP contributions that may be made for a particular employee. Under the provision, contributions are included in an employee's income to the extent they exceed the lesser of 25 percent of compensation or $40,000 (for 2002), subject to a reduction in some cases. Under present law, the Secretary of the Treasury has the authority to require an employer who makes contributions to a SEP to provide simplified reports with respect to such contributions. Consistent with present law and the provision, such reports could appropriately include information as to compliance with the requirements that apply to SEPs, including the contribution limits.

Additional salary reduction catch-up contributions.--Under EGTRRA, an individual aged 50 or over may make additional elective deferrals ("catch-up contributions") to certain retirement plans, up to a specified limit. A plan may not permit catch-up deferrals in excess of this limit. The provision clarifies that, for this purpose, the limit applies to all qualified retirement plans, tax-sheltered annuity plans, SEPs and SIMPLE plans maintained by the same employer on an aggregated basis, as if all plans were a single plan. The limit applies also to all eligible deferred compensation plans of a government employer on an aggregated basis. Under EGTRRA, catch-up contributions up to the specified limit are excluded from an individual's income. The provision also clarifies that the total amount that an individual may exclude from income as catch-up contributions for a year cannot exceed the catch-up contribution limit for that year (and for that type of plan), without regard to whether the individual made catch-up contributions under plans maintained by the more than one employer. The provision clarifies that an individual who will attain age 50 by the end of the taxable year is an eligible participant as of the beginning of the taxable year rather than only at the attainment of age 50.

The provision also clarifies that a participant in an eligible deferred compensation plan of a government employer may make catch-up contributions in an amount equal to the greater of the amount permitted under the new catch-up rule and the amount permitted under the special catch-up rule for eligible deferred compensation plans. The provision revises the lists of requirements that do not apply to catch-up contributions to reflect other statutory amendments made by the Act and to reflect the fact that catch-up contributions can be made only to a qualified defined contribution plan, not to a qualified defined benefit plan. The provision also clarifies that the special nondiscrimination rule for mergers and acquisitions applies for purposes of the nondiscrimination requirement applicable to catch-up contributions.

Equitable treatment for contributions of employees to defined contribution plans.-- Under prior law, the limits on contributions to a tax-sheltered annuity plan applied at the time contributions became vested. Under the Act, tax-sheltered annuity plans are generally subject to the same contribution limits as qualified defined contribution plans, but certain special rules were retained. The provision clarifies that the limits apply to contributions to a tax-sheltered annuity plan in the year the contributions are made without regard to when the contributions become vested. The provision also clarifies that contributions may be made for an employee for up to five years after retirement, based on includible compensation for the last year of service before retirement. The provision also restores special rules for ministers and lay employees of churches and for foreign missionaries that were inadvertently eliminated. Under the ActEGTRRA, amounts deferred under an eligible deferred compensation plan are generally subject to the same contribution limits as qualified defined contribution plans. The provision conforms the definition of compensation used in applying the limits to an eligible deferred compensation plan to the definition used for defined contribution plans.

Rollovers of retirement plan and IRA distributions.--Under prior law and under the Act, a qualified retirement plan must provide for the rollover of certain distributions directly to a qualified defined contribution plan, a qualified annuity plan, a tax-sheltered annuity plan, a governmental eligible deferred compensation plan, or a traditional IRA, if the participant elects a direct rollover. The provision clarifies that a qualified retirement plan must provide for the direct rollover of after-tax contributions only to a qualified defined contribution plan or a traditional IRA. The provision also clarifies that, if a distribution includes both pretax and after-tax amounts, the portion of the distribution that is rolled over is treated as consisting first of pretax amounts.

Employers may disregard rollovers for purposes of cash-out amounts.-- Under prior and present law, if a participant in a qualified retirement plan ceases to be employed with the employer maintaining the plan, the plan may distribute the participant's nonforfeitable accrued benefit without the consent of the participant and, if applicable, the participant's spouse, if the present value of the benefit does not exceed $5,000. Under the Act, a plan may provide that the present value of the benefit is determined without regard to the portion of the benefit that is attributable to rollover contributions (and any earnings allocable thereto) for purposes of determining whether the participant must consent to the cash-out of the benefit.

The provision clarifies that rollover amounts may be disregarded also in determining whether a spouse must consent to the cash-out of the benefit.

Notice of significant reduction in plan benefit accruals.-- Under EGTRRA, notice must be provided to participants if a defined benefit plan is amended to provide for a significant reduction in the future rate of benefit accrual, including any elimination or reduction of an early retirement benefit or retirement-type subsidy. The provision clarifies that the notice requirement applies to a defined benefit plan only if the plan is qualified. The provision further clarifies that, in the case of an amendment that eliminates an early retirement benefit or retirement-type subsidy, notice is required only if the early retirement benefit or retirement-type subsidy is significant. The provision also eliminates inconsistencies in the statutory language.

Modification of timing of plan valuations.--Under EGTRRA, a plan valuation may be made as of any date in the immediately preceding plan year if, as of such date, plan assets are not less than 100 percent of the plan's current liability. Under EGTRRA, a change in funding method to use a valuation date in the prior year generally may not be made unless, as of such date, plan assets are not less than 125 percent of the plan's current liability. The provision conforms the statutory language to Congressional intent as reflected in the Statement of Managers.

ESOP dividends may be reinvested without loss of dividend deduction.--Under prior and present law, a deduction is permitted for a dividend paid with respect to employer stock held in an ESOP if the dividend is (1) paid in cash directly to participants or (2) paid to the plan and subsequently distributed to the participants in cash no later than 90 days after the close of the plan year in which the dividend is paid to the plan. The deduction is allowable for the taxable year of the corporation in which the dividend is paid or distributed to the participants. Under EGTRRA, in addition to the deductions permitted under present law, a deduction is permitted for a dividend paid with respect to employer stock that, at the election of the participants, is payable in cash directly to participants or paid to the plan and subsequently distributed to the participants in cash no later than 90 days after the close of the plan year in which the dividend is paid to the plan, or paid to the plan and reinvested in qualifying employer securities. Under the provision, the deduction for dividends that are reinvested in qualifying employer securities at the election of participants is allowable for the taxable year in which the later of the reinvestment or the election occurs. The provision also clarifies that a dividend that is reinvested in qualifying employer securities at the participant's election must be nonforfeitable.

Technical Amendments Made by Job Creation Act of 2002 Related to Consolidated Appropriations Act 2001

Phaseout of $25,000 amount for certain rental real estate under passive loss rules.--Present law provides for a phaseout of the $25,000 amount allowed in the case of certain deductions and certain credits with respect to rental real estate activities, for taxpayers with adjusted gross income exceeding $100,000. The phaseout rule does not apply, or applies separately, in the case of the rehabilitation credit, the low-income housing credit, and the commercial revitalization deduction. The provision clarifies the operation of the ordering rules to reflect the exceptions and separate phaseout rules for these items.

Treatment of missing children.--Present law provides that in the case of a dependent child of the taxpayer that is kidnapped, the taxpayer may continue to treat the child as a dependent for purposes of the dependency exemption, child credit, surviving spouse filing status, and head of household filing status. A similar rule applies under the earned income credit. The provision clarifies that, if a taxpayer met the household maintenance requirement of the surviving spouse filing status or the head of household filing status, respectively, with respect to his or her dependent child immediately before the kidnapping, then the taxpayer would be deemed to continue to meet that requirement for purposes of the filing status rule of section 2 of the Code until the child would have reached age 18 or is determined to be dead.

Basis of property in an exchange by a corporation involving assumption of liabilities.--The provision clarifies that the basis reduction rule of section 358(h) of the Code gives rise to a basis reduction in the amount of any liability that is assumed by another party as part of the exchange in which the property (whose basis exceeds its fair market value) is received, so long as the other requirements under section 358(h) apply.

Tax treatment of securities futures contracts.--The provision clarifies that the termination of a securities contract is treated in a manner similar to a sale or exchange of a securities futures contract for purposes of determining the character of any gain or loss from a termination of a securities futures contract. Under the provision, any gain or loss from the termination of a securities futures contract (other than a dealer securities futures contract) is treated as gain or loss from the sale or exchange of property that has the same character as the property to which the contract relates has (or would have) in the hands of the taxpayer. The provision also clarifies that losses from the sale, exchange, or termination of a securities futures contract (other than a dealer securities futures contract) to sell generally are treated in the same manner as losses from the closing of a short sale for purposes of applying the wash sale rules.

Thus, the wash sale rules apply to any loss from the sale, exchange, or termination of a securities futures contract (other than dealer securities futures contract) if, within a period beginning 30 days before the date of such sale, exchange, or termination and ending 30 days after such date: (1) stock that is substantially identical to the stock to which the contract relates is sold; (2) a short sale of substantially identical stock is entered into; or (3) another securities futures contract to sell substantially identical stock is entered into. The provision clarifies that a securities futures contract to sell generally is treated in a manner similar to a short sale for purposes of the special holding period rules in section 1233. Thus, subsections (b) and (d) of section 1233 may apply to characterize certain capital gains as short-term capital gain and certain capital losses as long-term capital loss, and to determine holding periods where certain securities futures contracts to sell are entered into while holding the substantially identical stock.

Technical Amendments Made by Job Creation Act of 2002 Related to the Taxpayer Relief Act of 1997

Election to recognize gain on assets held on January 1, 2001; treatment of gain on sale of principal residence.--The provision clarifies that the gain to which the mark-to-market election applies is included in gross income. Thus, the exclusion of gain on the sale of a principal residence under Code section 121 would not apply with respect to an asset for which the election to mark to market is made. The provision is consistent with the holding of Rev. Rul. 2001-57.

Election to recognize gain on assets held on January 1, 2001; treatment of disposition of interest in passive activity.--The provision clarifies that the election to mark to market an interest in a passive activity does not result in the deduction of suspended losses by reason of section 469(g)(1)(A). Any gain taken into account by reason of an election with respect to any interest in a passive activity is taken into account in determining the passive activity loss for the taxable year (as defined in section 469(d)(1)). Section 469(g)(1)(A) may apply to a subsequent disposition of the interest in the activity by the taxpayer.

Technical Amendments Made by Job Creation Act of 2002 Related to other Acts

Coordination of wash sale rules and section 1256 contracts.--The bill clarifies that the wash sale rules do not apply to any loss arising from a section 1256 contract. This rule is similar to the rule in present-law section 475 applicable to securities that are marked to market under that section. The provision is effective as if included in section 5075 of the Technical and Miscellaneous Revenue Act of 1988.

Determination of whether a life insurance contract is a modified endowment contract.--The provision clarifies that, for purposes of determining whether a life insurance contract is a modified endowment contract, if there is a material change to the contract, appropriate adjustments are made in determining whether the contract meets the 7-pay test to take into account the cash surrender value under the contract.

No reference is needed to the cash surrender under the "old contract" (as was provided under section 318(a)(2) of H.R. 5662, the Community Renewal Tax Relief Act of 2000 (Pub. Law No. 106-554)) because prior and present law provide a definition of cash surrender value for this purpose (by cross reference to section 7702(f)(2)(A)). It is reiterated that Code section 7702A(c)(3)(ii) is not intended to permit a policyholder to engage in a series of "material changes" to circumvent the premium limitations in section 7702A. Thus, if there is a material change to a life insurance contract, it is intended that the fair market value of the contract be used as the cash surrender value under the provision, if the amount of the putative cash surrender value of the contract is artificially depressed. For example, if there is a material change because of an increase in the face amount of the contract, any artificial or temporary reduction in the cash surrender value of the contract is not to be taken into account, but rather, it is intended that the fair market value of the contract be used as cash surrender value, so that the substance rather than the form of the transaction is reflected. Further, as stated in the 1988 Act legislative history to section 7702A,55 in applying the 7-pay test to any premiums paid under a contract that has been materially changed, the 7-pay premium for each of the first 7 contract years after the change is to be reduced by the product of (1) the cash surrender value of the contract as of the date that the material change takes effect (determined without regard to any increase in the cash surrender value that is attributable to the amount of the premium payment that is not necessary), and (2) a fraction the numerator of which equals the 7-pay premium for the future benefits under the contract, and the denominator of which equals the net single premium for such benefits computed using the same assumptions used in determining the 7-pay premium. The provision is effective as if section 318(a) of the Community Renewal Tax Relief Act of 2000 (114. Stat. 2763A-645) had not been enacted.

Clerical amendments The bill makes a number of clerical and typographical amendments to the IRC.

28. Technical Amendments

This bill would make eight technical amendments to the Revenue and Taxation Code. Two of the technical amendments remove obsolete IRC references relating to installment sales, one adds a Corporations Code reference relating to penalties, two of the amendments relate to involuntary conversions and are clean-up to SB 519 (Stat. 1998, Ch. 7), two amendments update cross-references in the CTL, and one amendment updates state conformity to a federal technical change to the rules for electing 1987 partnerships. No revenue is associated with any of these "code maintenance" technical amendments.